An Overview of the U.S. Economy

Presented by Daniel North, Euler Hermes ACI, September 21st , 2010

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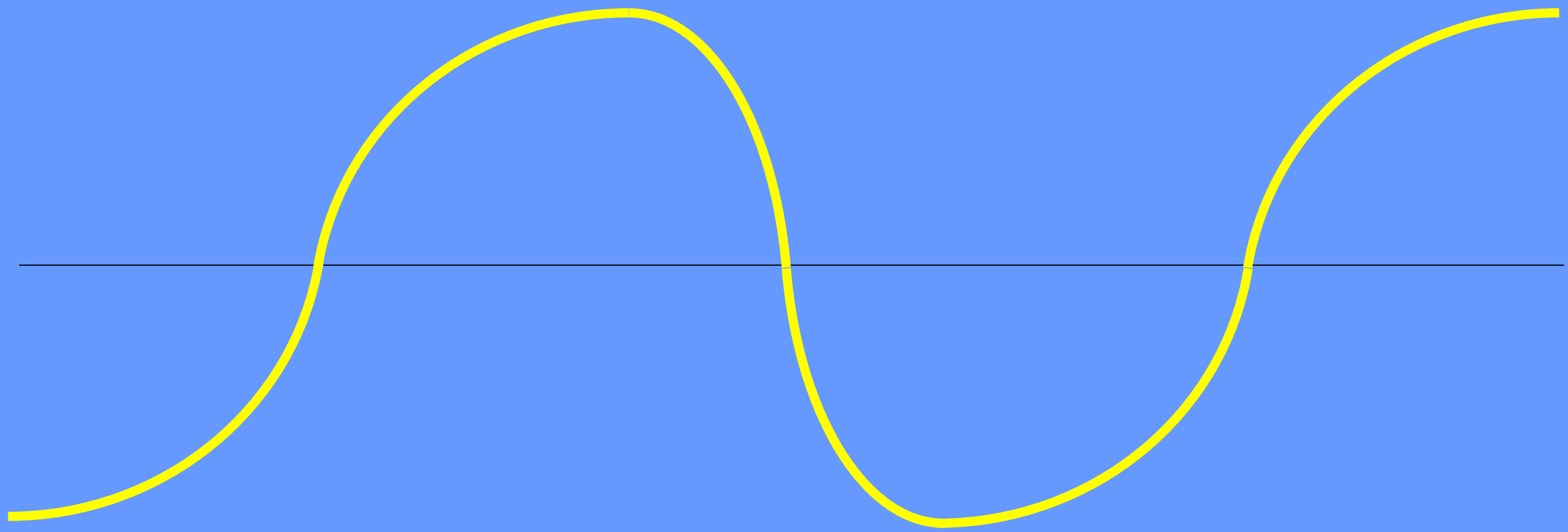
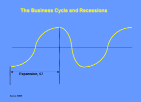
The Overview, September, 2010

- Economy Recovering
- Recovery Threatened
    - Inflation / Deflation
- Government Policies
- Risks, Conclusions, etc.

Not around here pal.

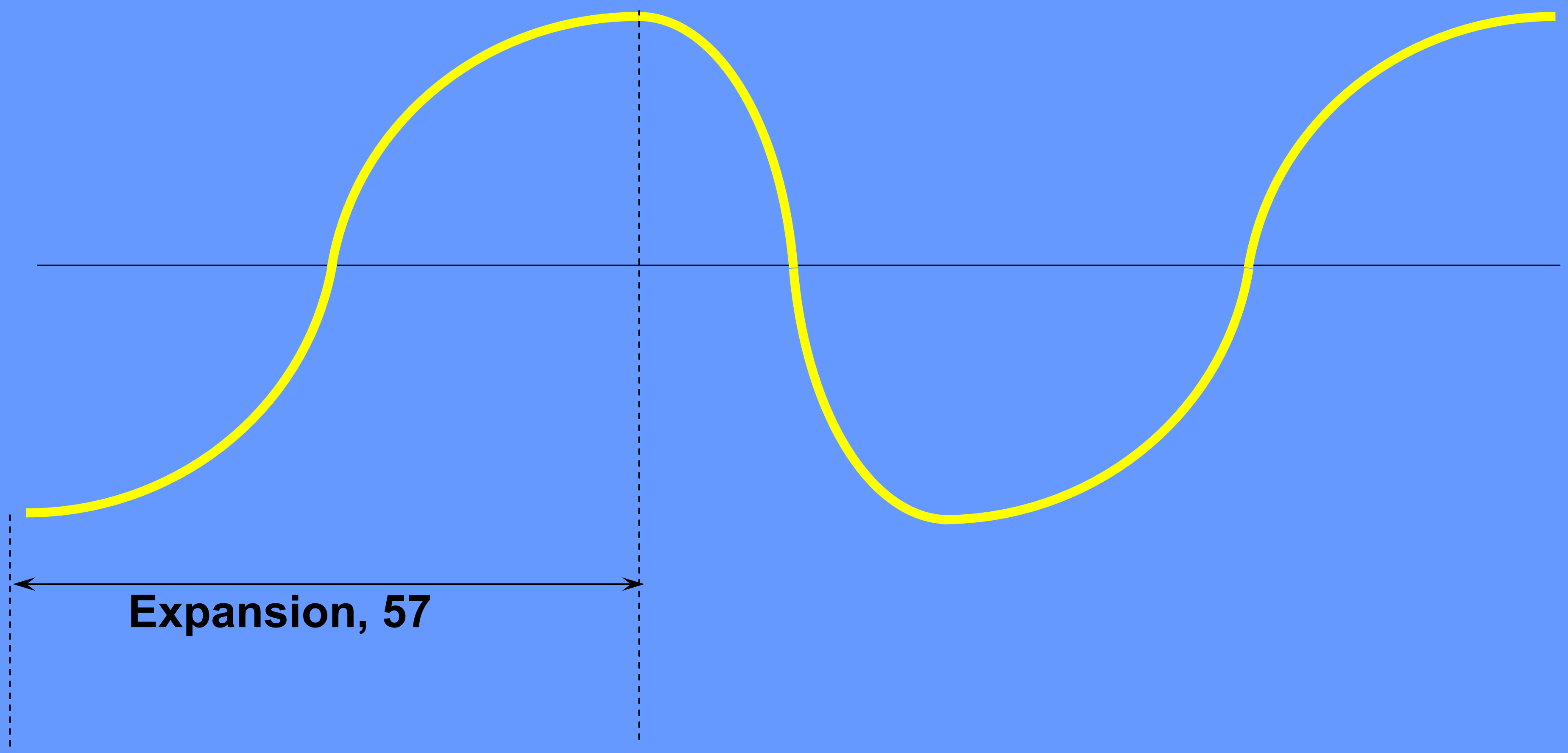
The Business Cycle and Recessions





Source: NBER

The Business Cycle and Recessions



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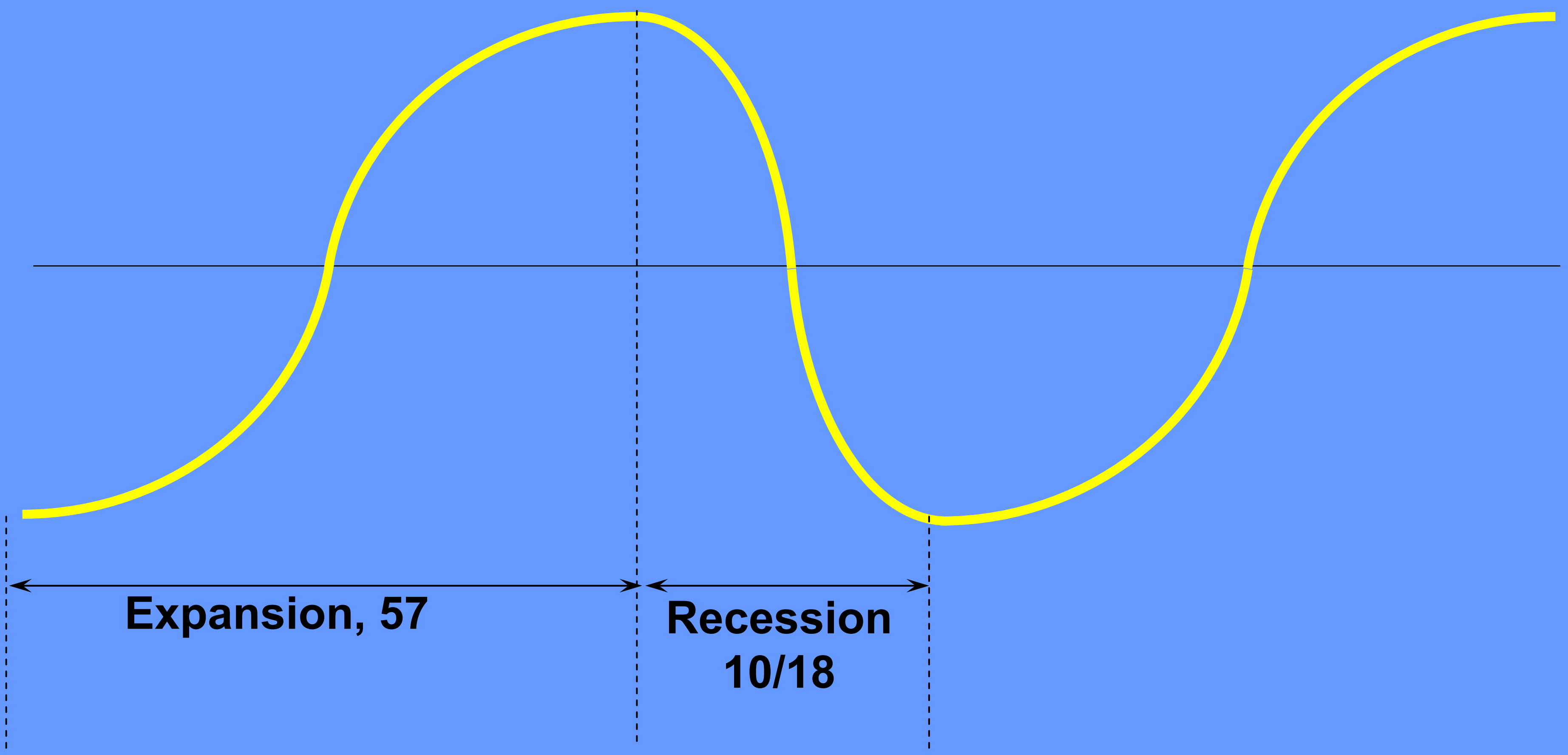

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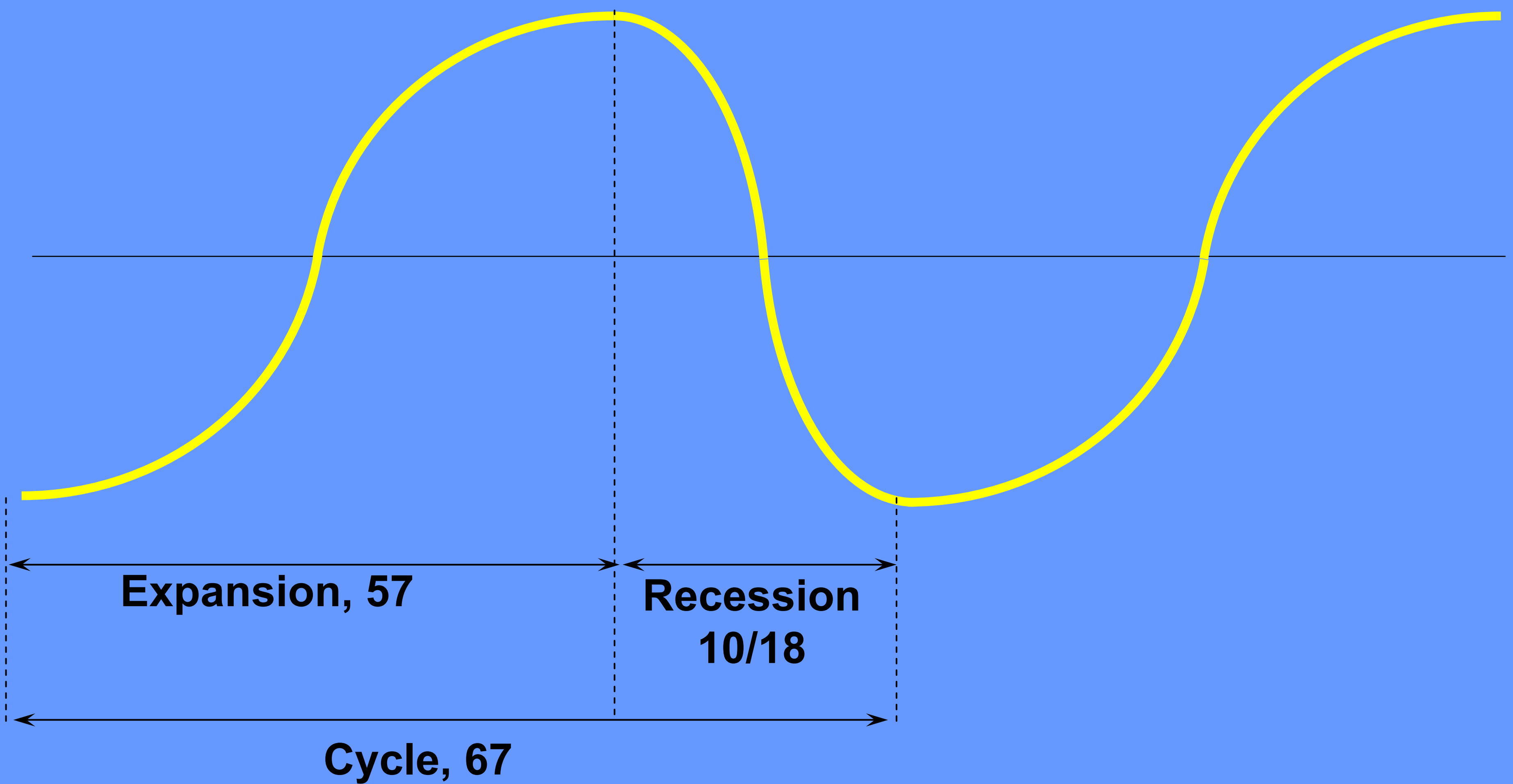

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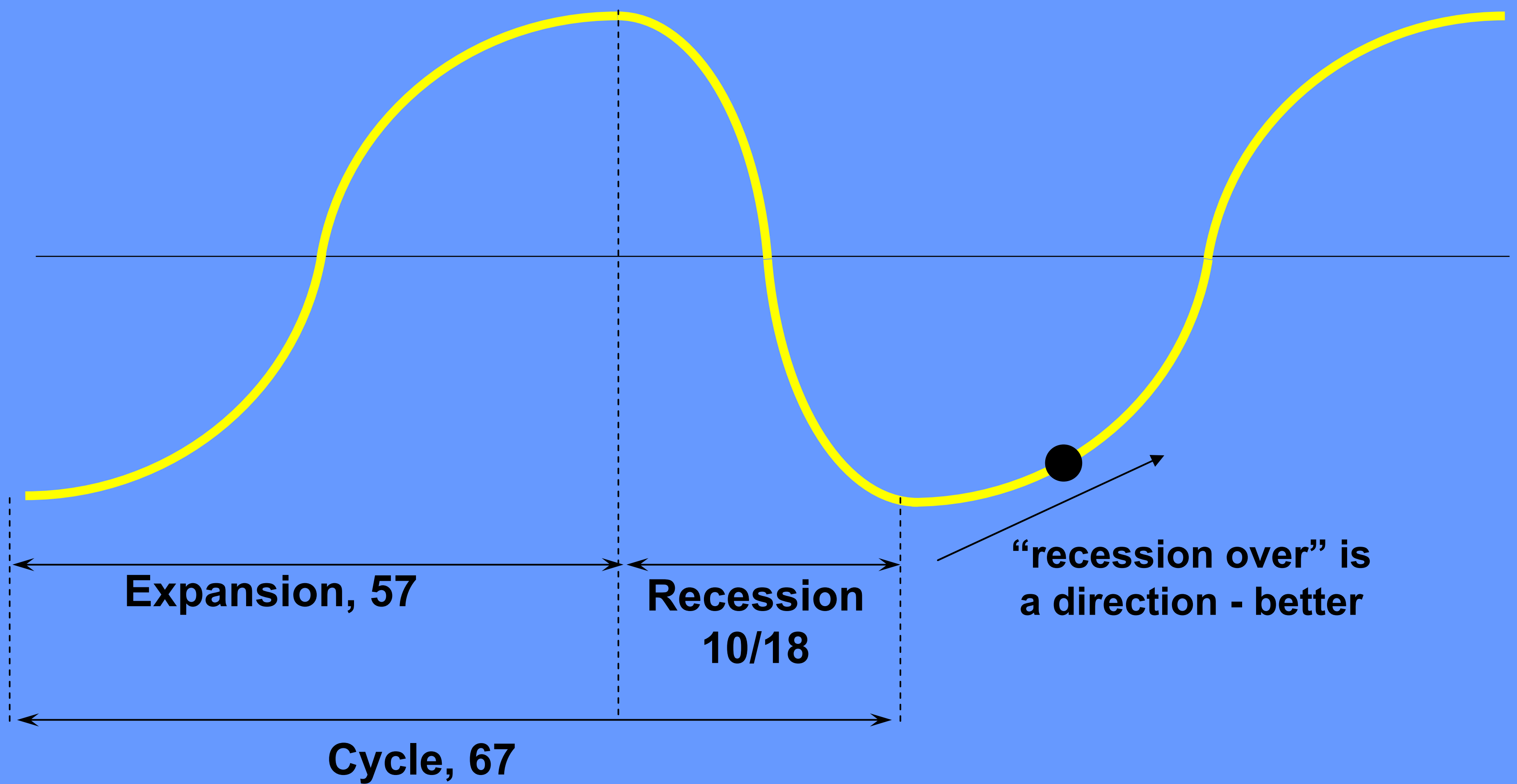

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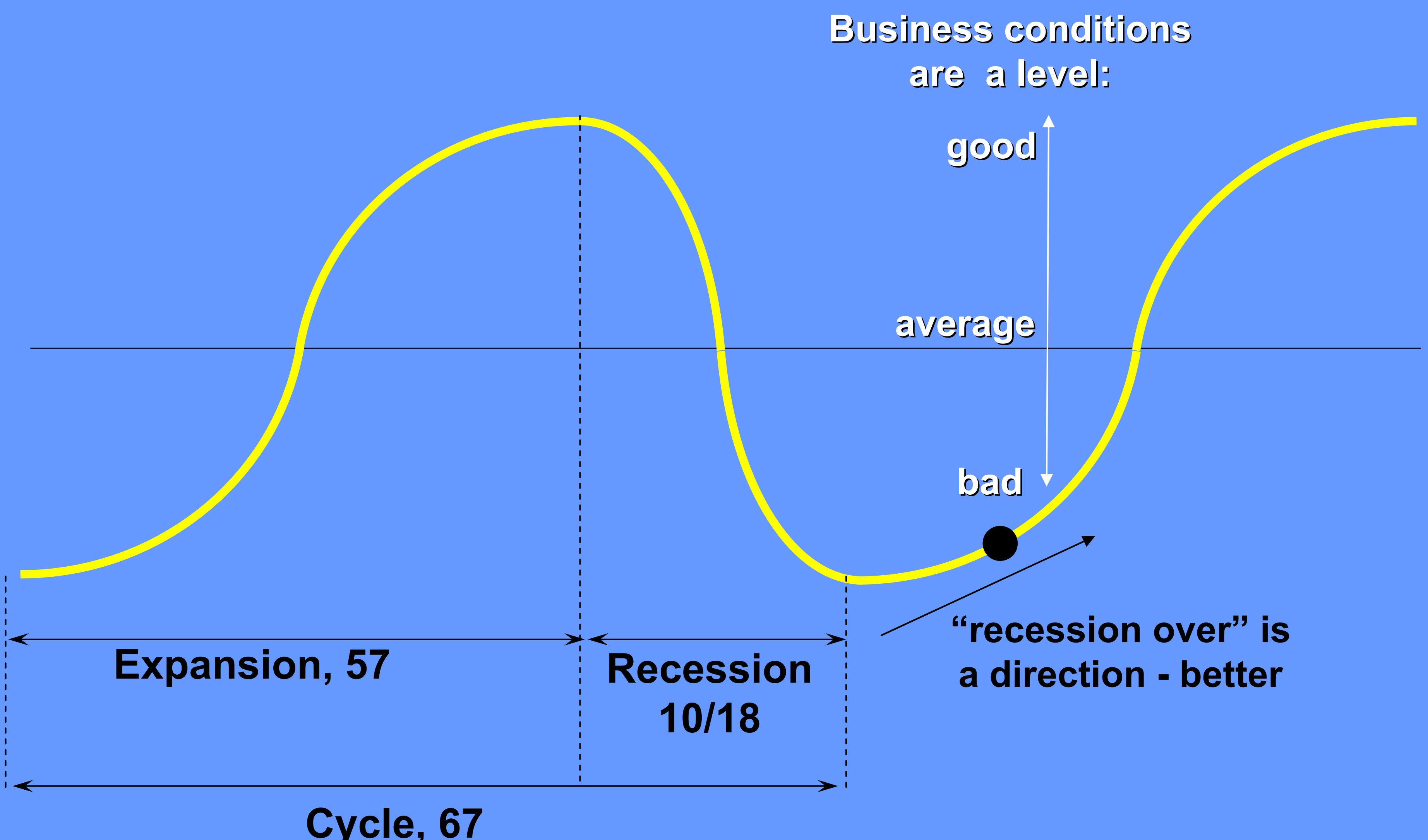

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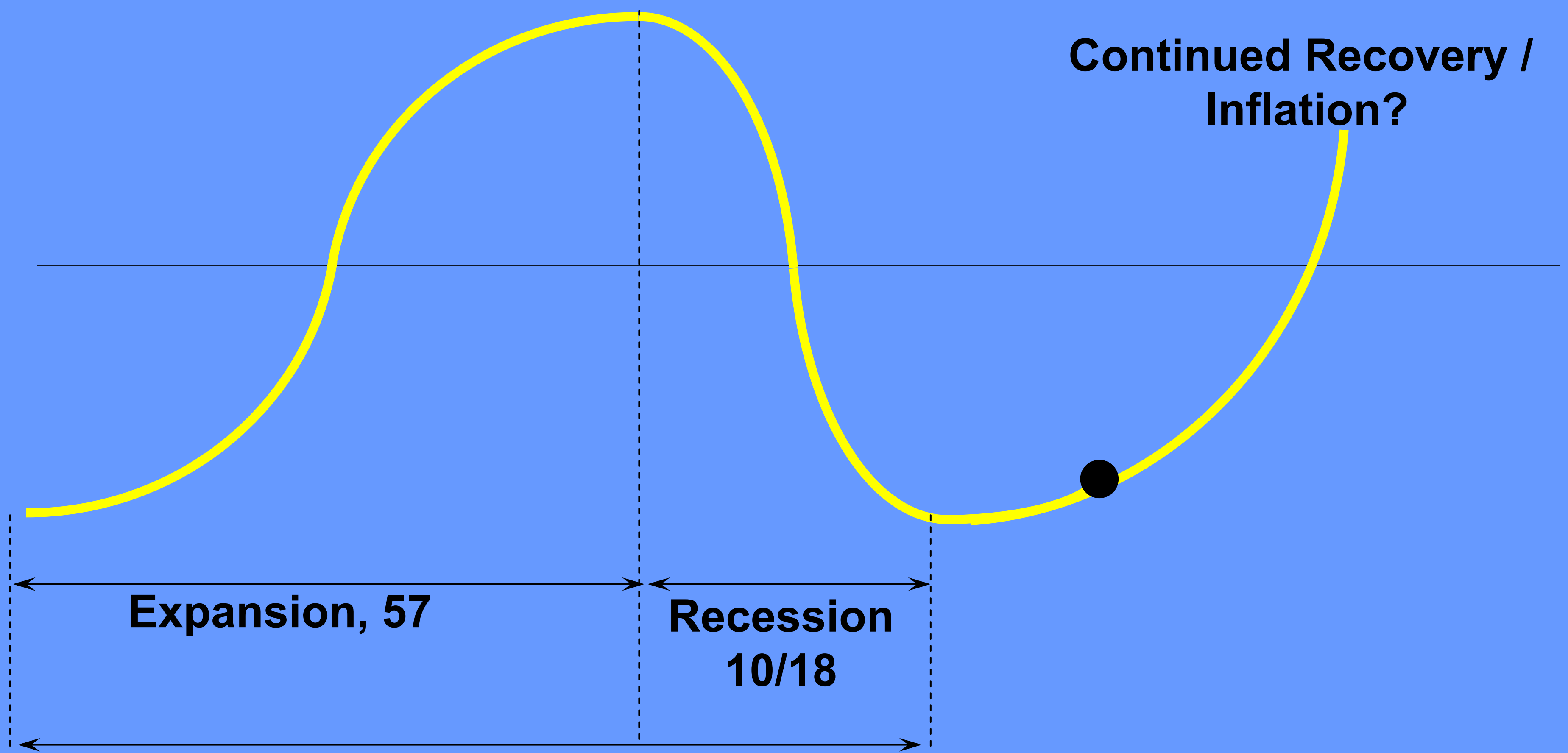

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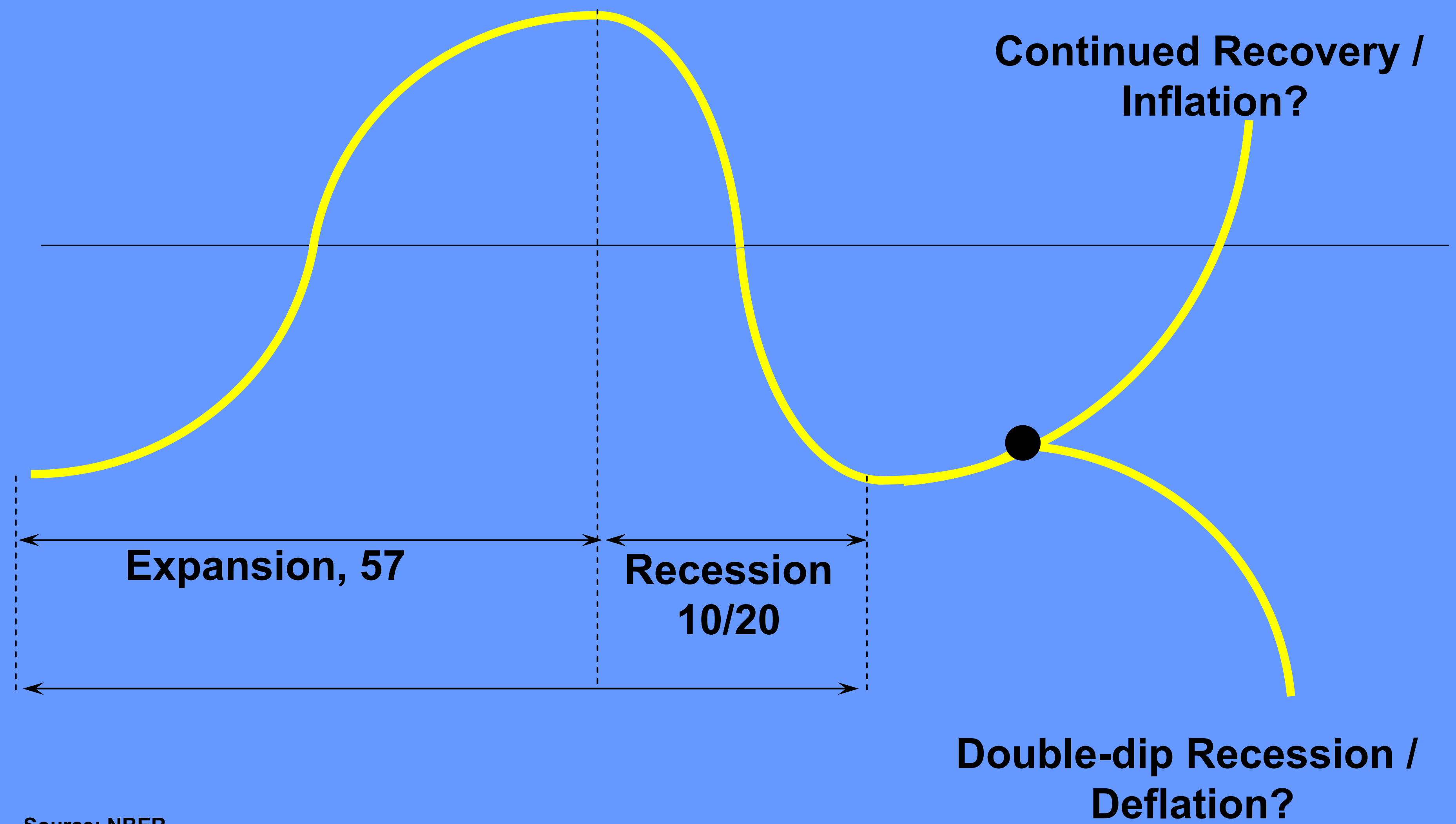

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The Overview, September 2010

- The recession is over but the recovery is weak
- Continued growth / inflation, or
- Double-dip / deflation?

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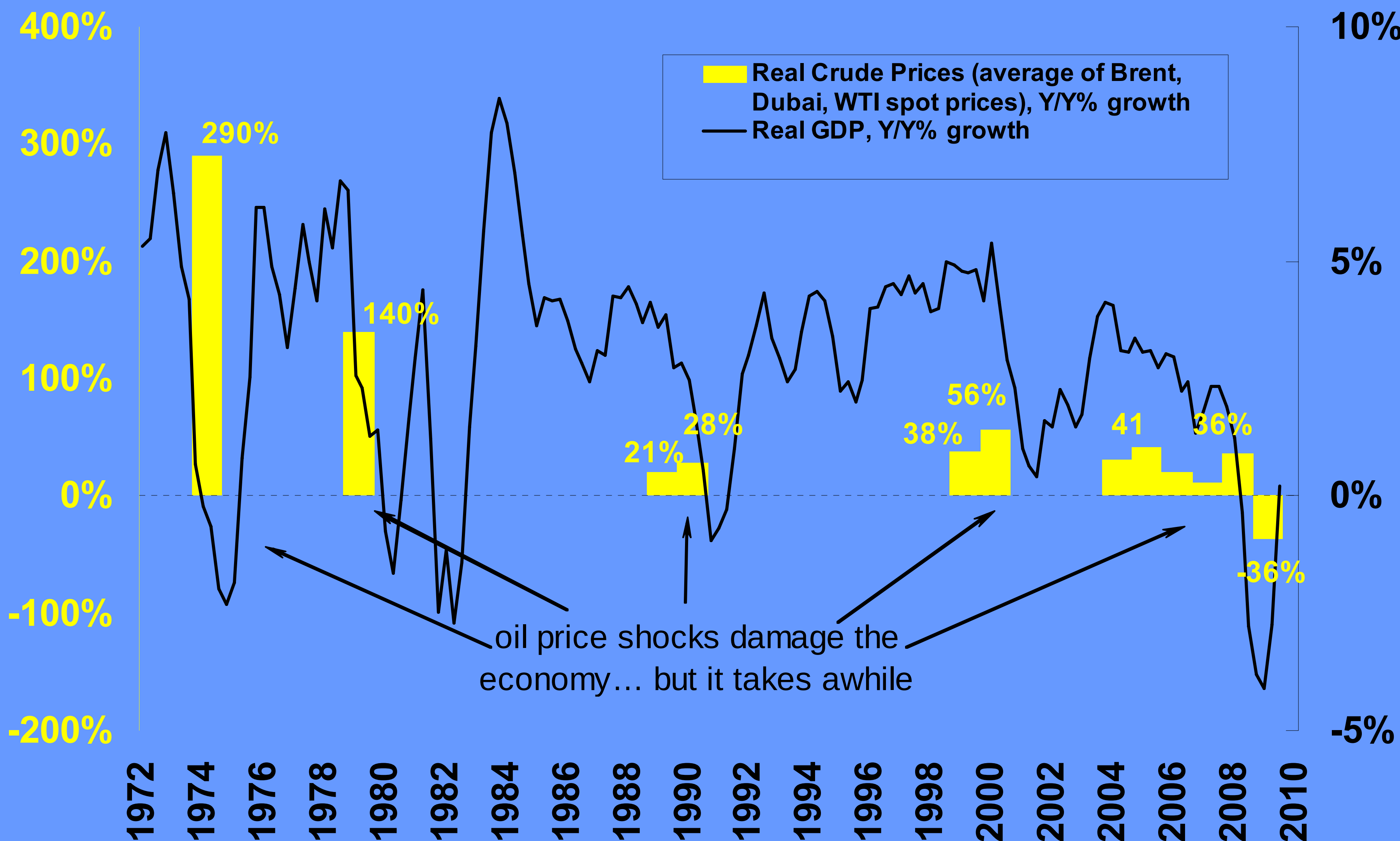
- The recession is over but the recovery is weak
- Continued growth / inflation, or
- Double-dip / deflation?

- The four forces which started and ended the recession hold answers:
  - Oil
  - Housing
  - Fed policies
  - Fear

(GDP: $14T, 3.3% ave. growth)

Oil Price Shocks and the Economy



Source: Dept. of Commerce, Dept. of Labor, World Bank, EHACI

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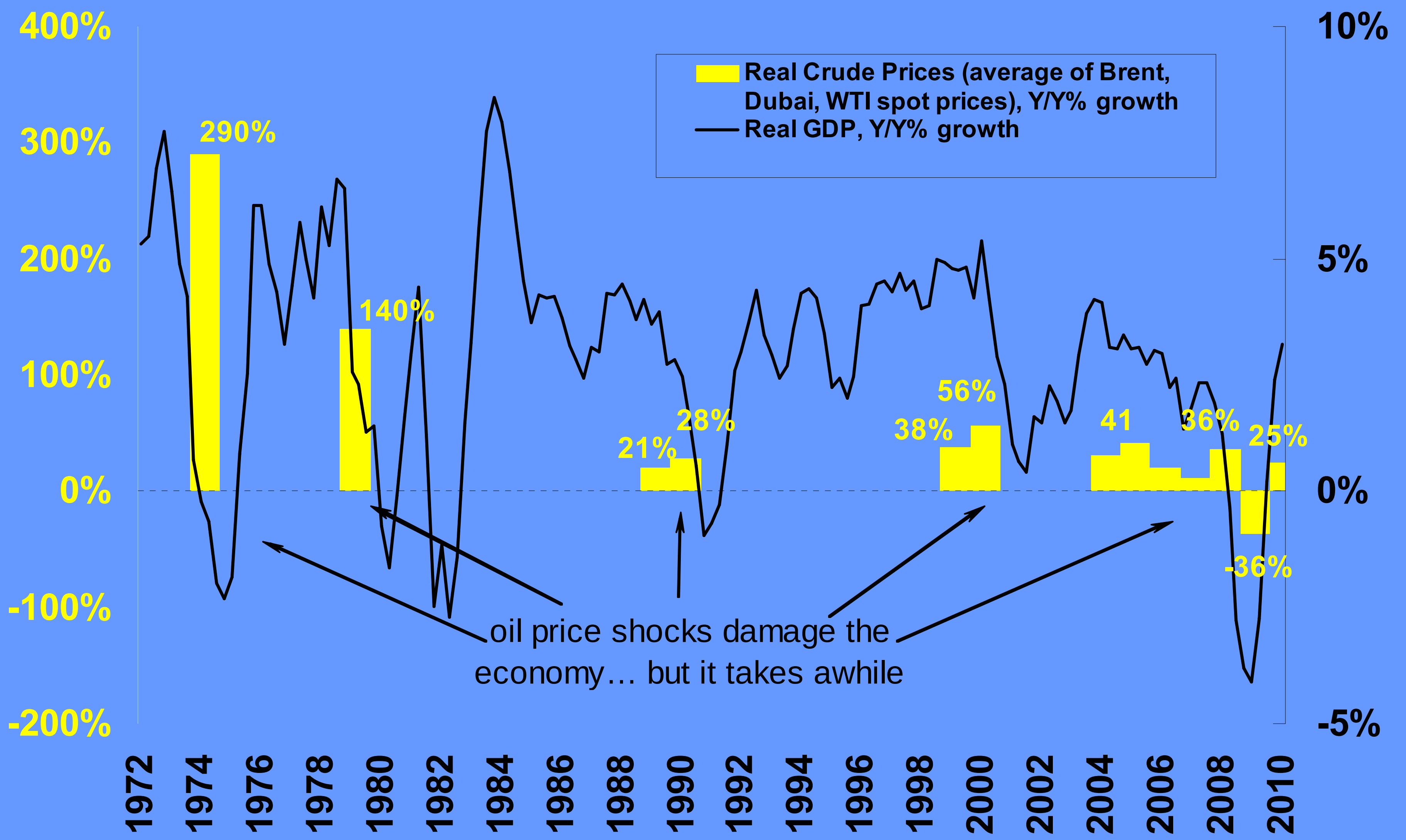

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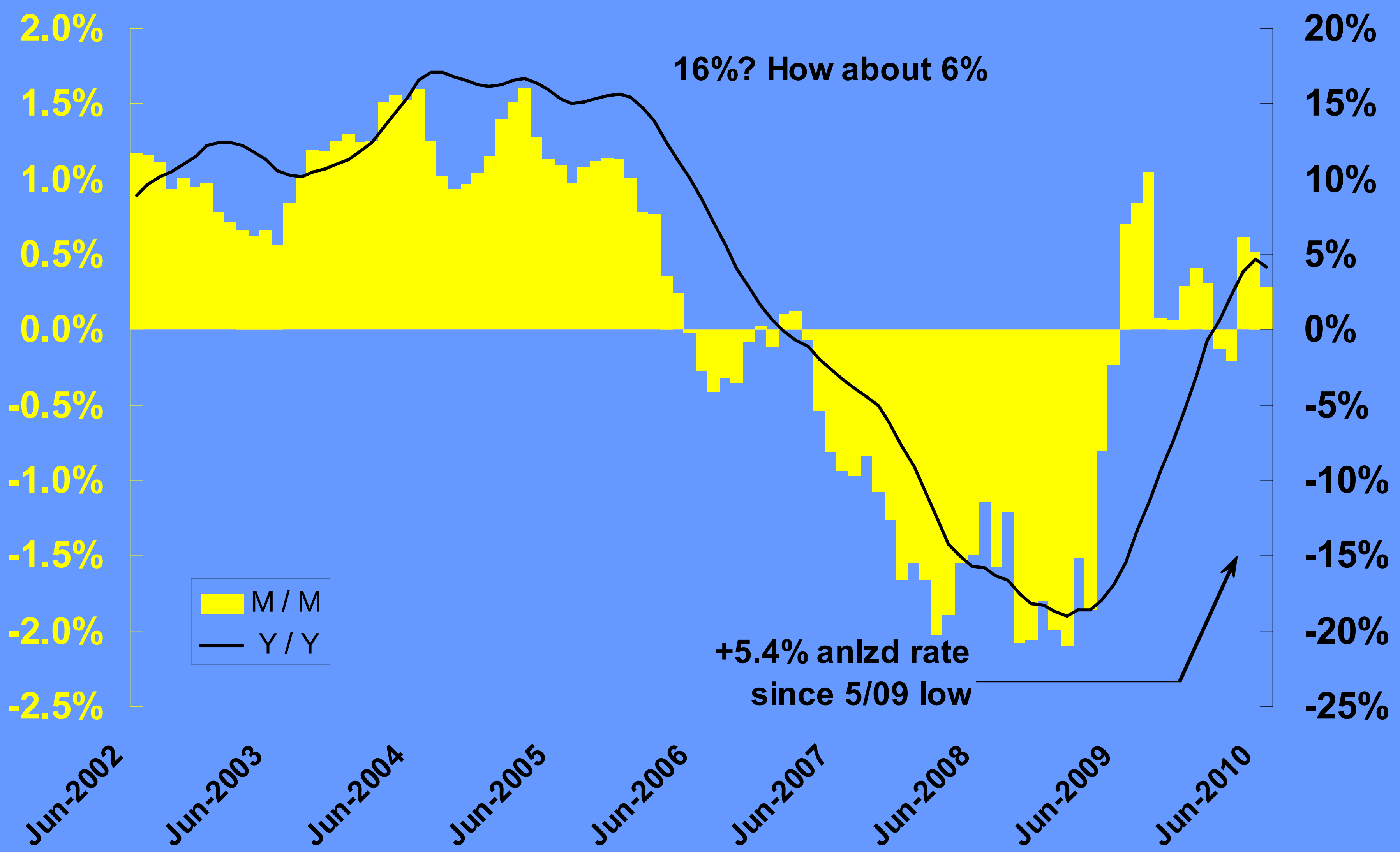
The Housing Market

Case - Shiller Home Price Index, % Change



S&P/Case-Shiller

The Housing Market

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A real mixed bag w/distortions from tax credit expiration

	Good	Not-so-Good
Unit sales, existing 1 family houses	up 11% 12mo/12mo	Fell 27% in July, sales have double-dipped
Unit sales, new 1 family houses	only 7% of market	record low in July
Median Prices existing 1 family houses	up 12% since low of 1/10	up only 1% y/y, double-dipped
Median Prices of new 1 family houses	Down only 2% since low of 4/10	down 5% y/y, double-dipped
Starts	up 14% since low of 4/9	down 7% y/y, 20% from 4/10 double-dipped
Permits	up 8% since low of 4/9	down 4% y/y, 18% from 3/10 double-dipped

More house

The Housing Market

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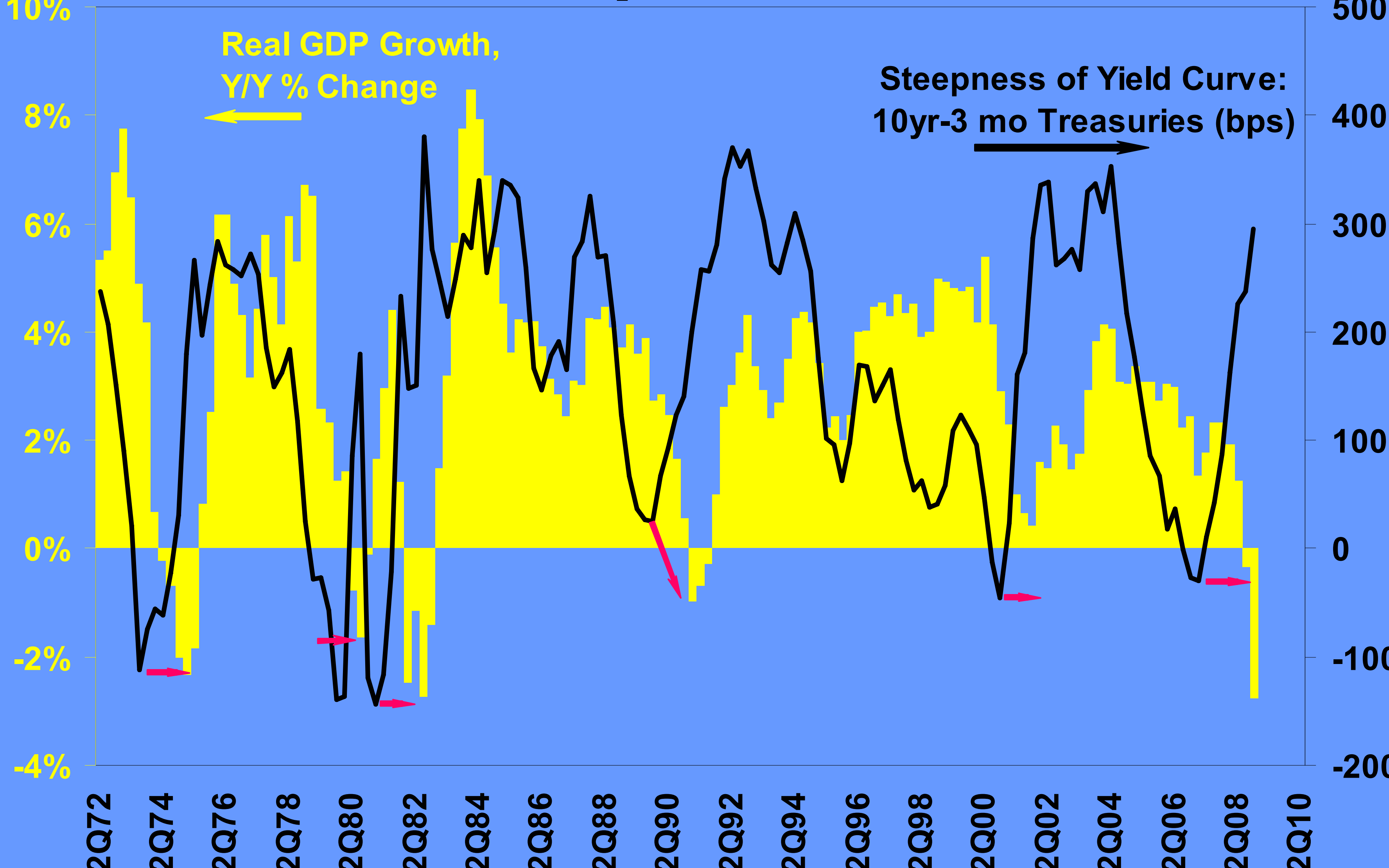
Remember, we knew the data would look weak after April, so we won't know for months yet what's really happening.

The Treasury Yield Curve vs. GDP



Source: Census Bureau, Federal Reserve

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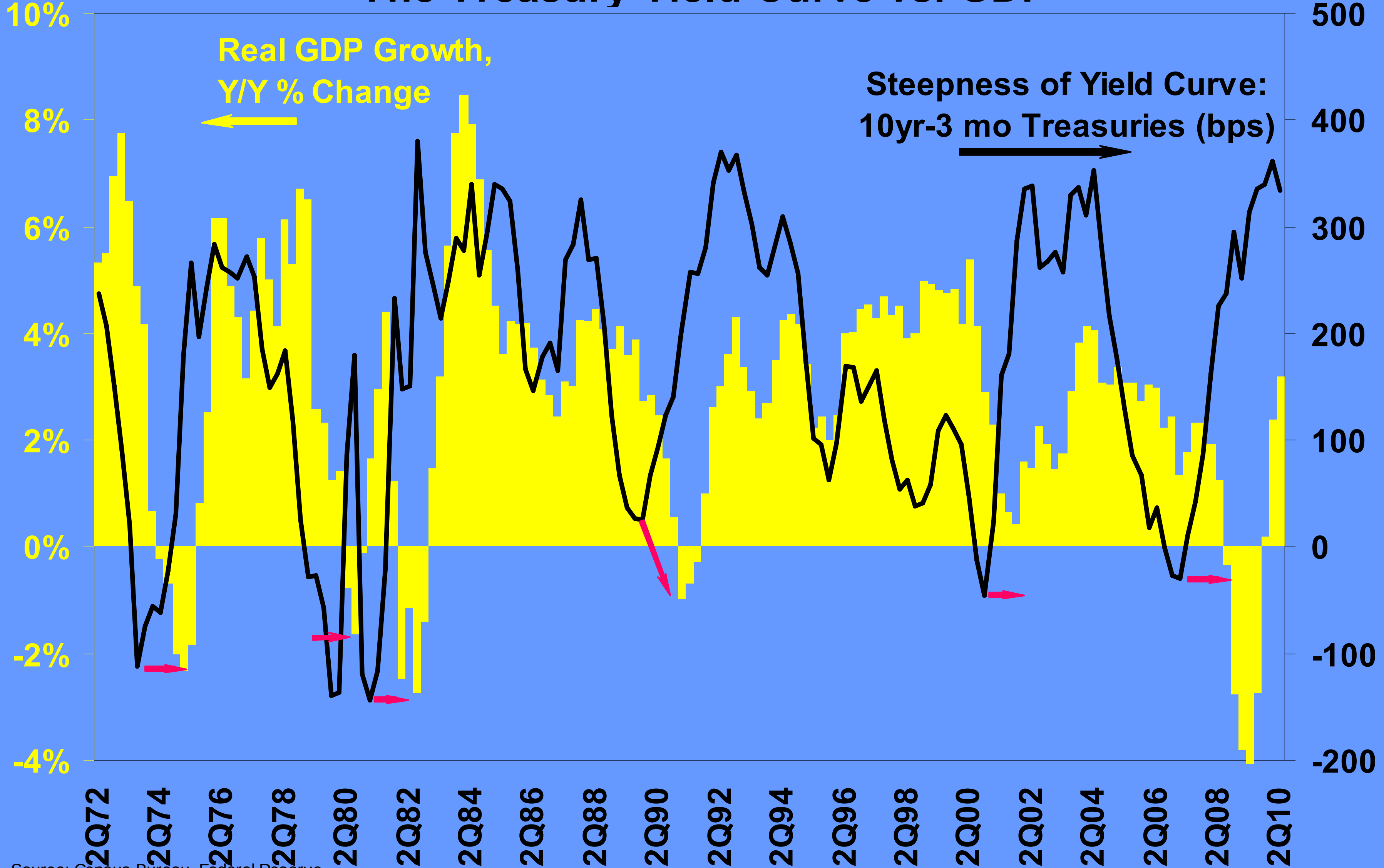

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fear

Yield Curve Steepness: 10 yr yield - 3 mo. yield (bps)
Uncomfortable trend, but still quite high

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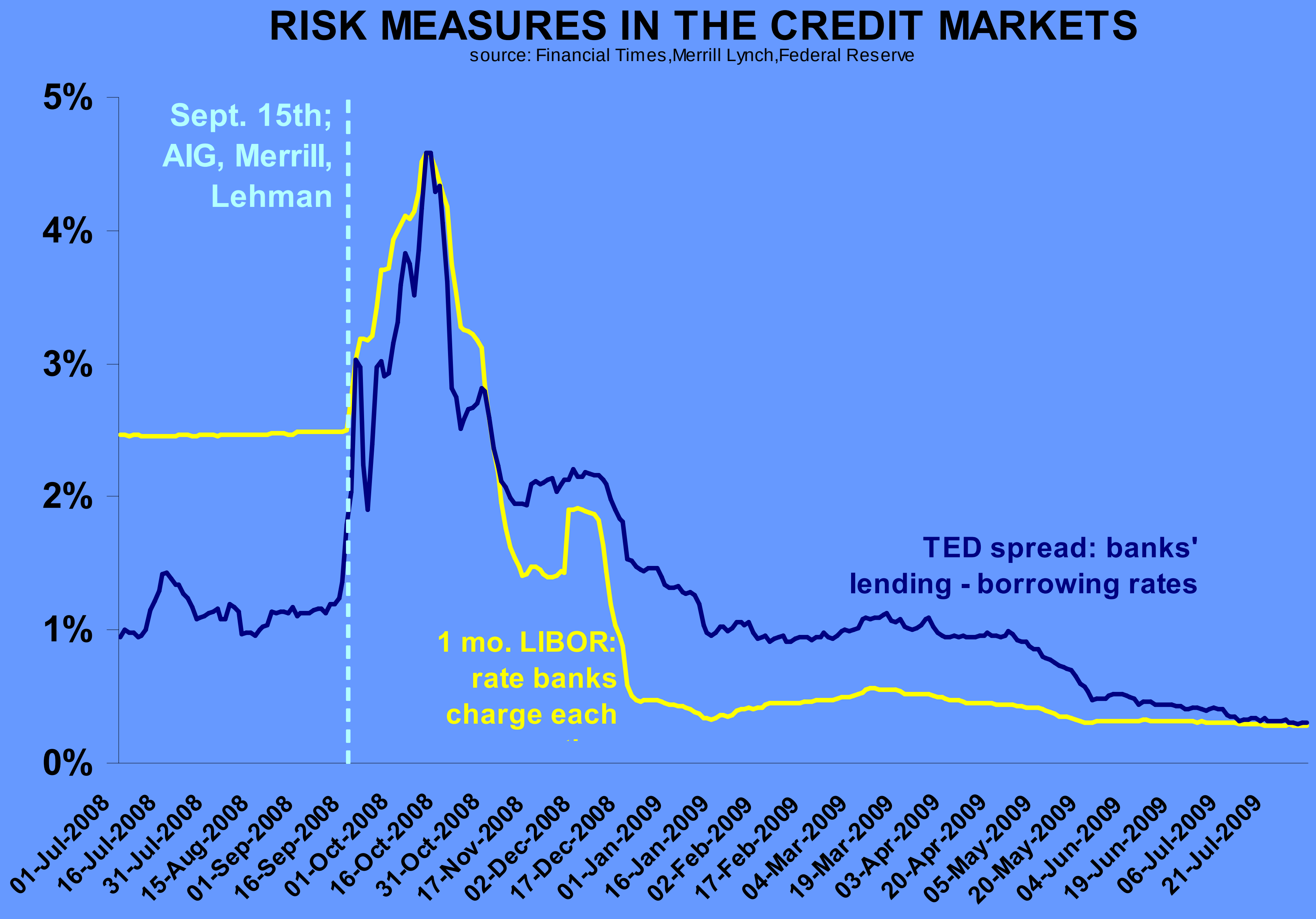
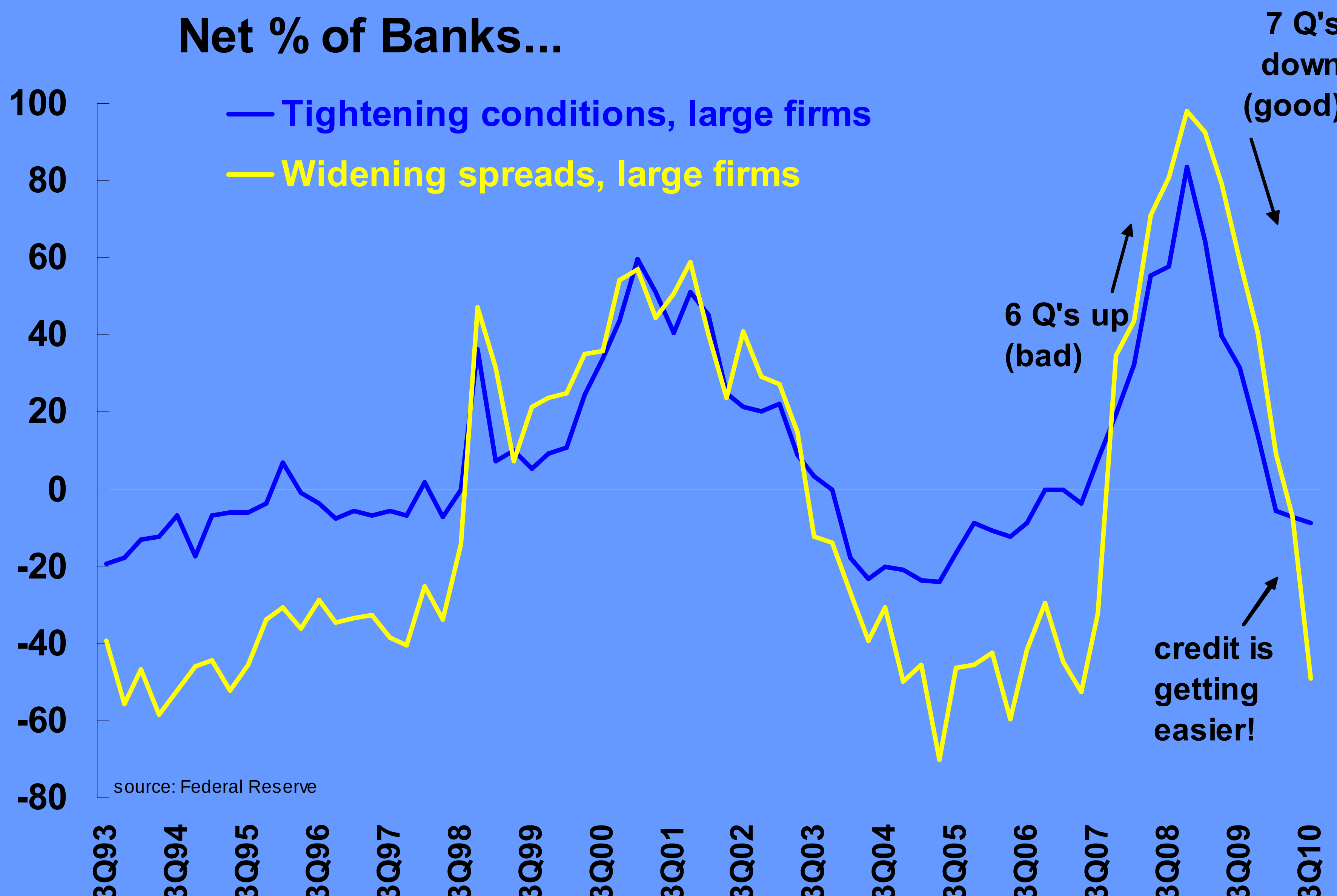
fear

How we got here - fear

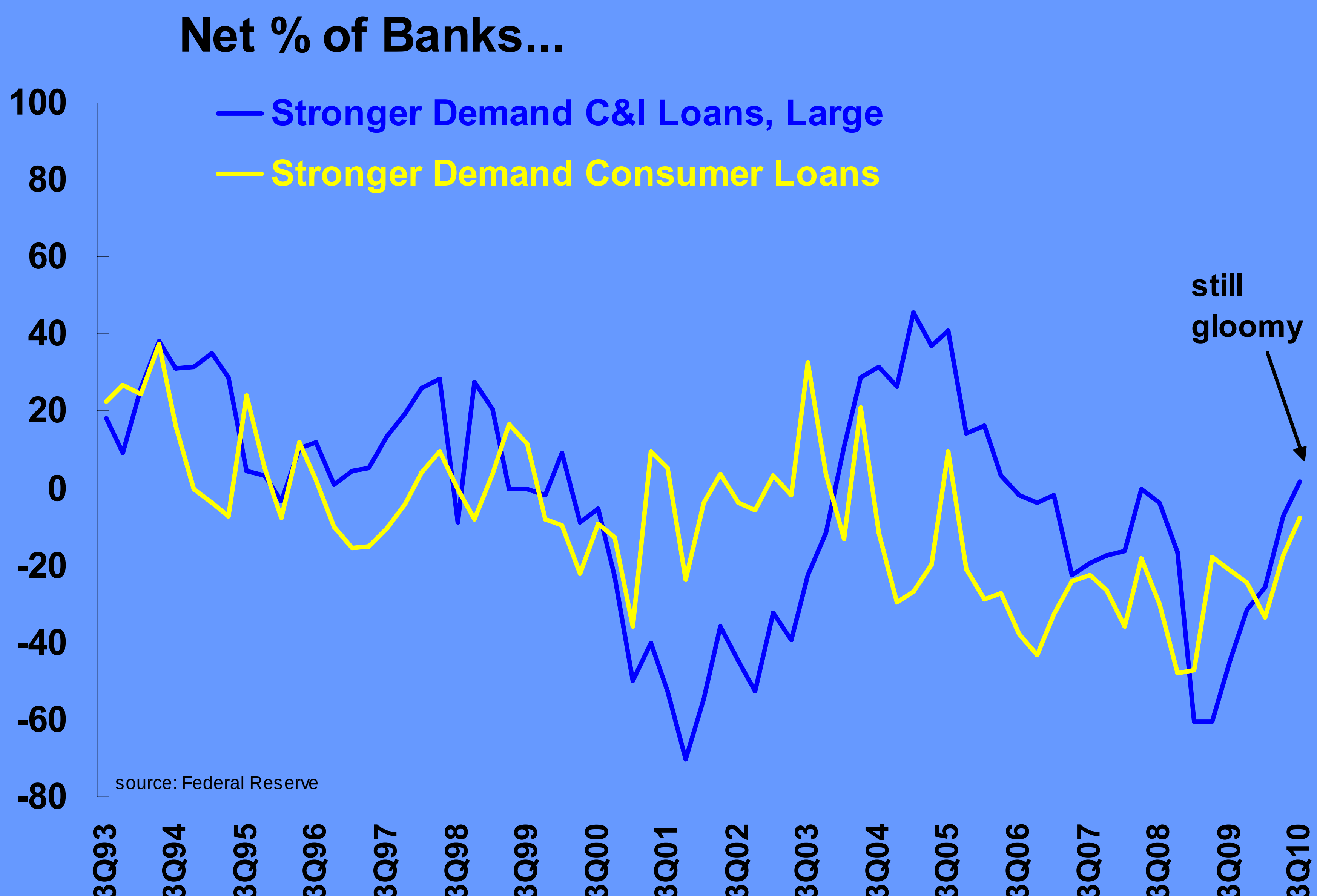


Fed

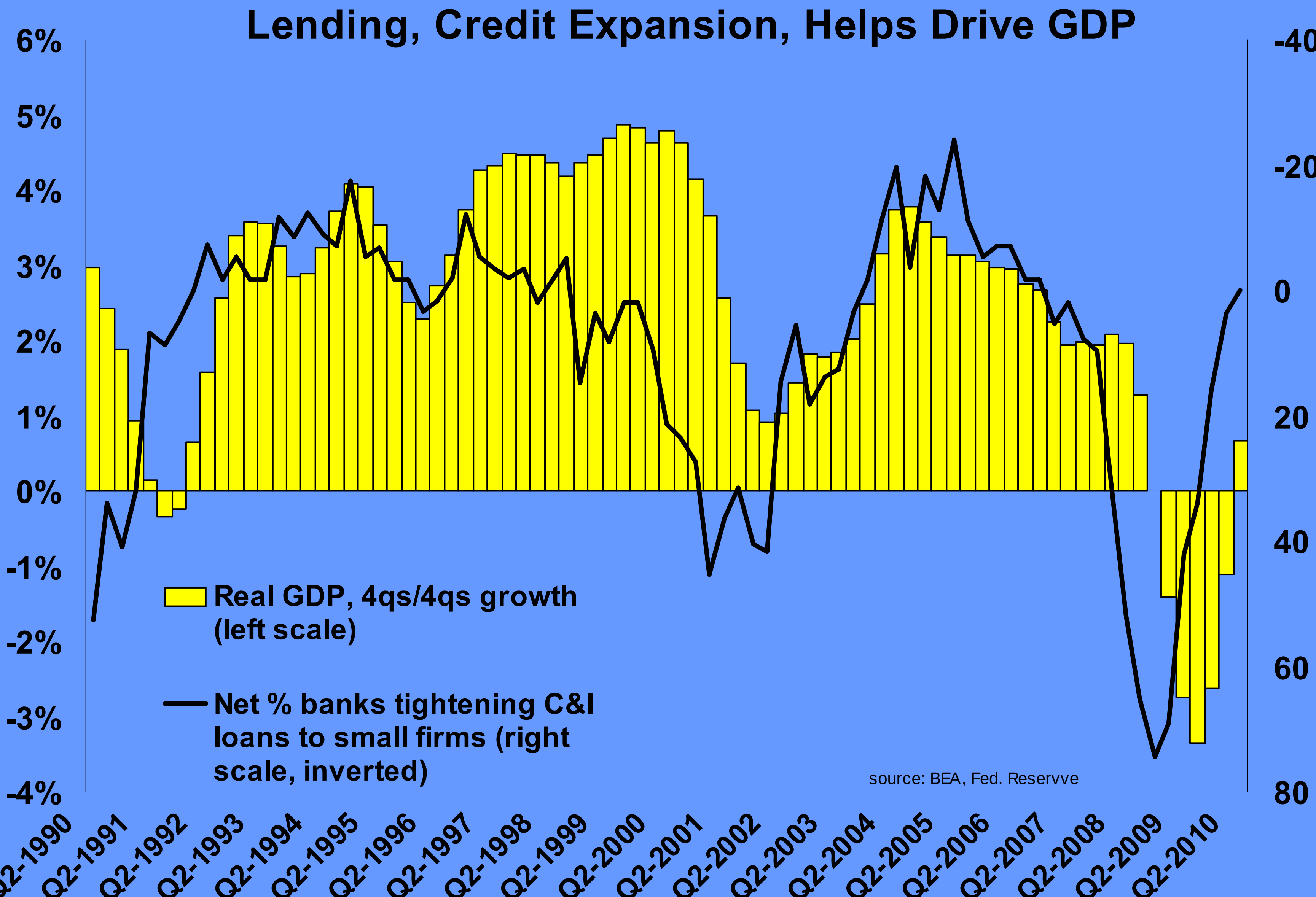
Fear receding; credit getting easier…



…but nobody wants it …



…but we need business to take it



4 forces, indctrs

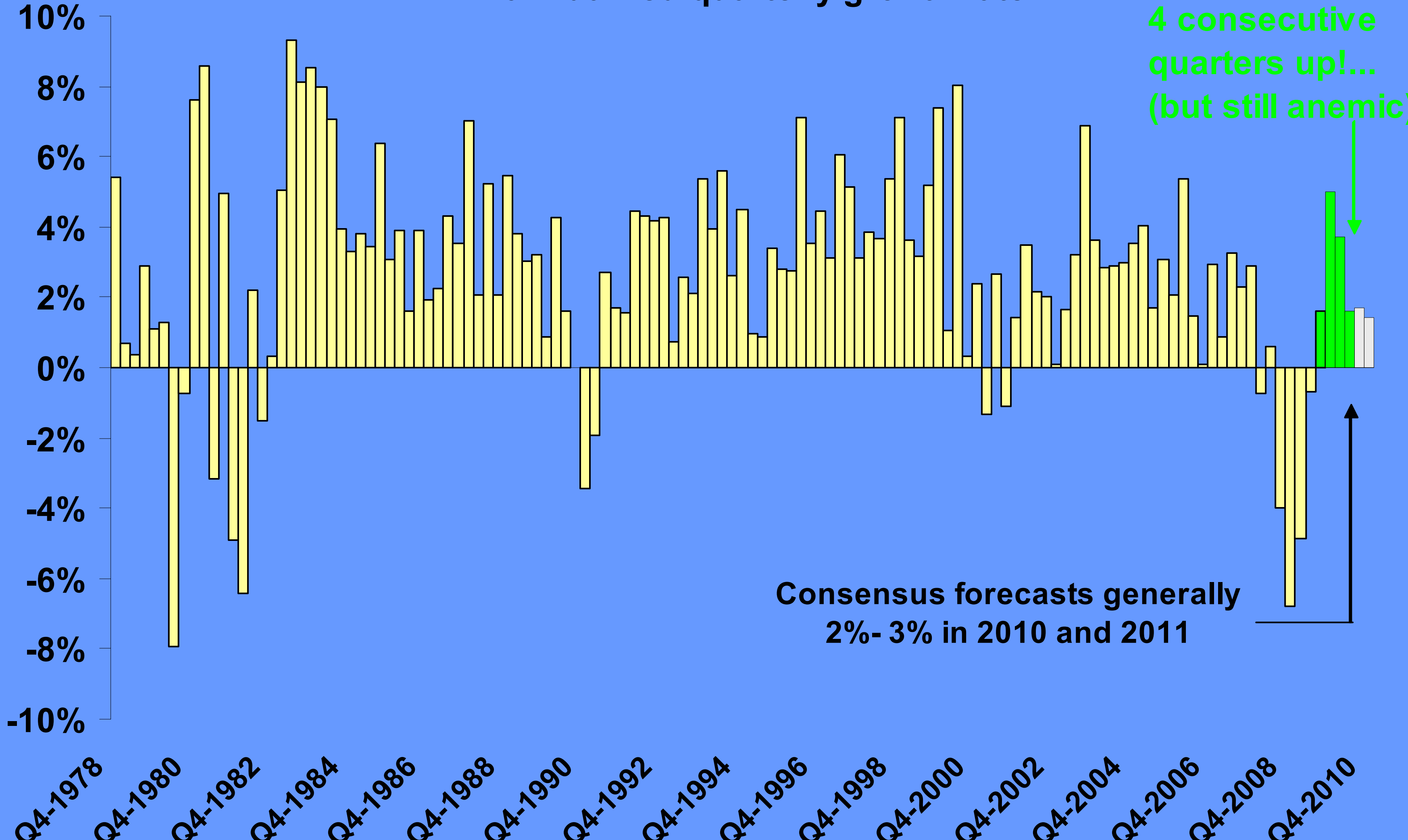
So the 4 forces:

- Got us into recession
- Got us out of recession
- And may be faltering

So what do the measures of the economy say?

Real Gross Domestic Product (GDP)

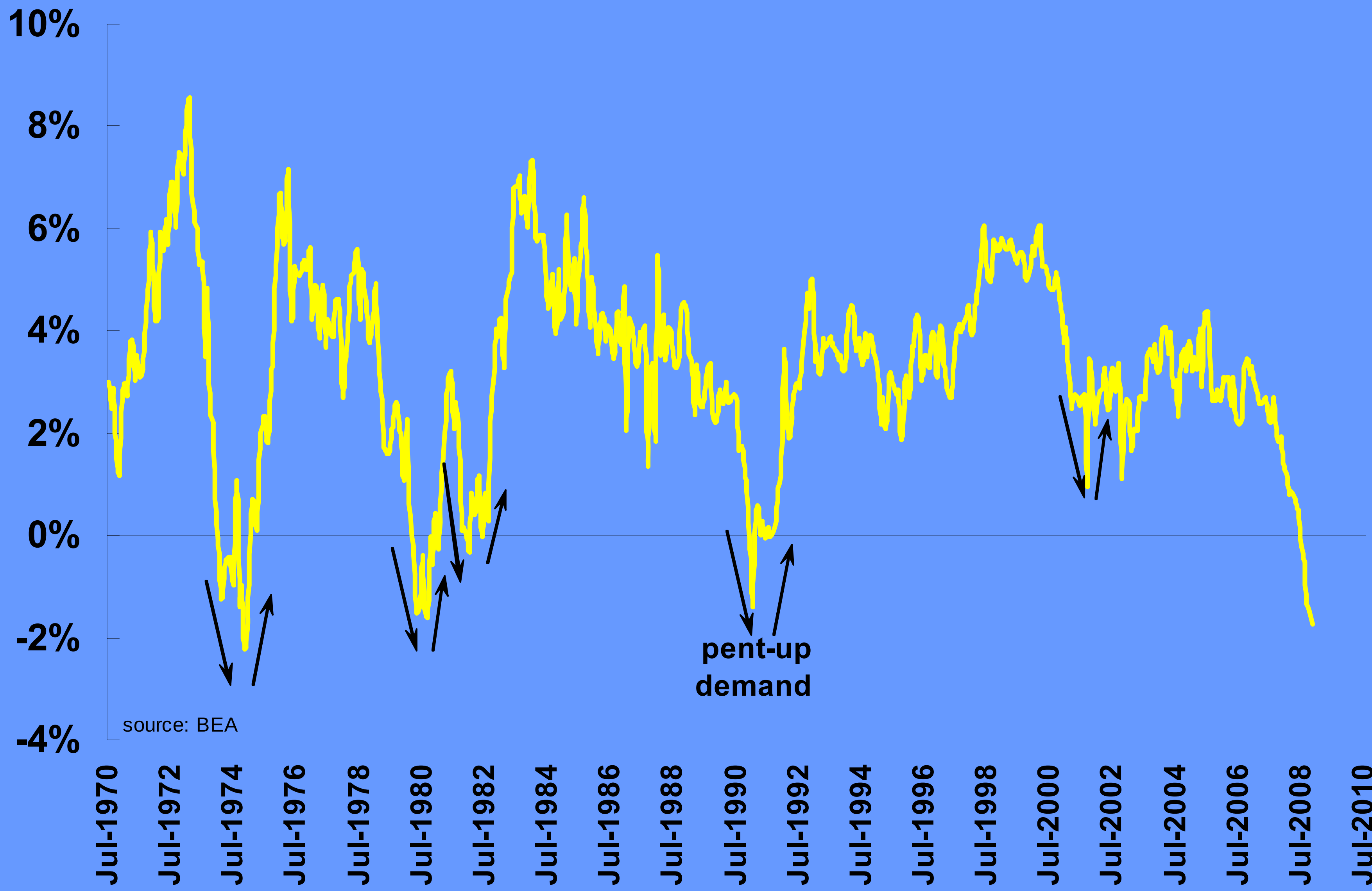
annualized quarterly growth rate



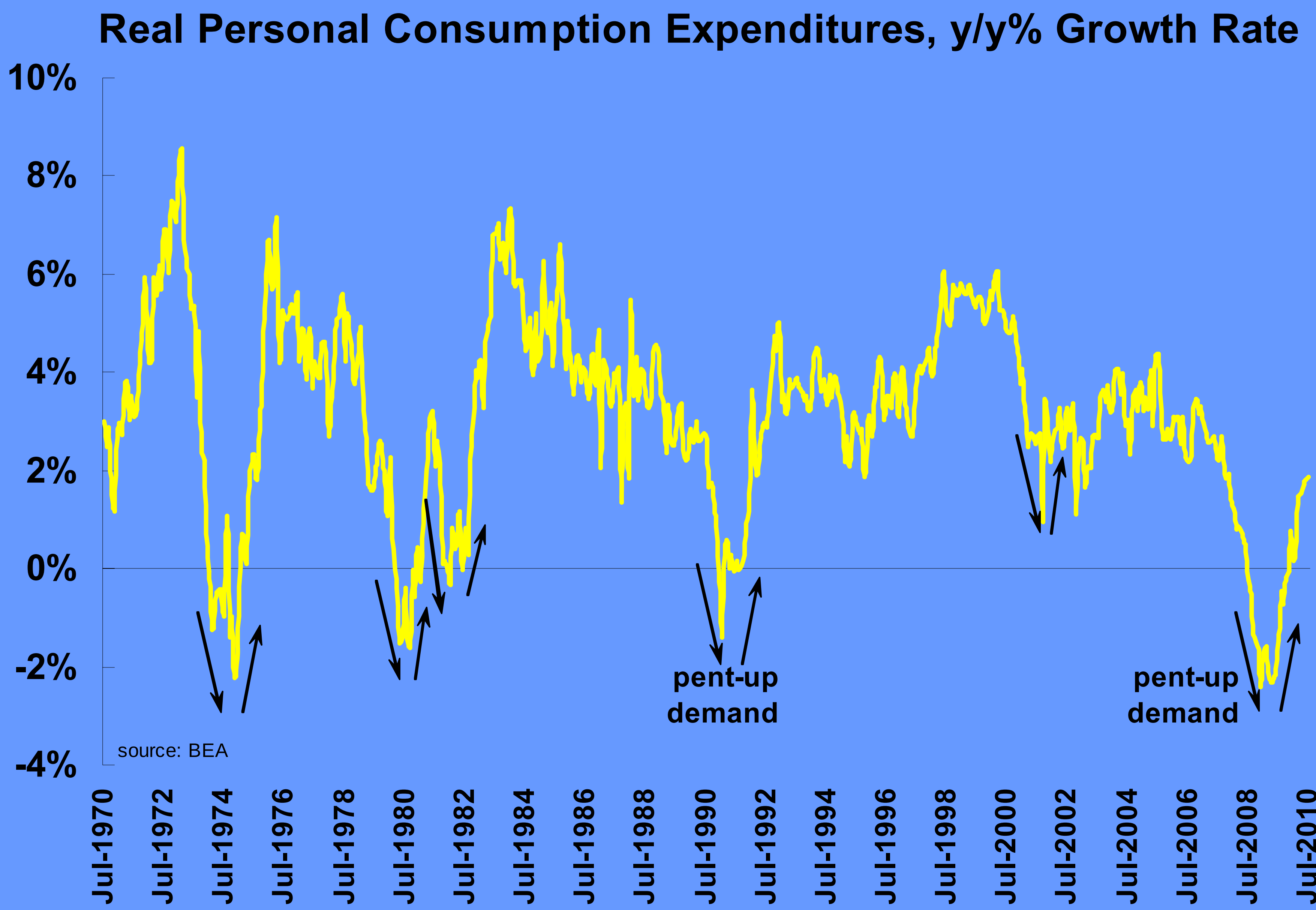
source: BEA

Consumer

Real Personal Consumption Expenditures, y/y% Growth Rate

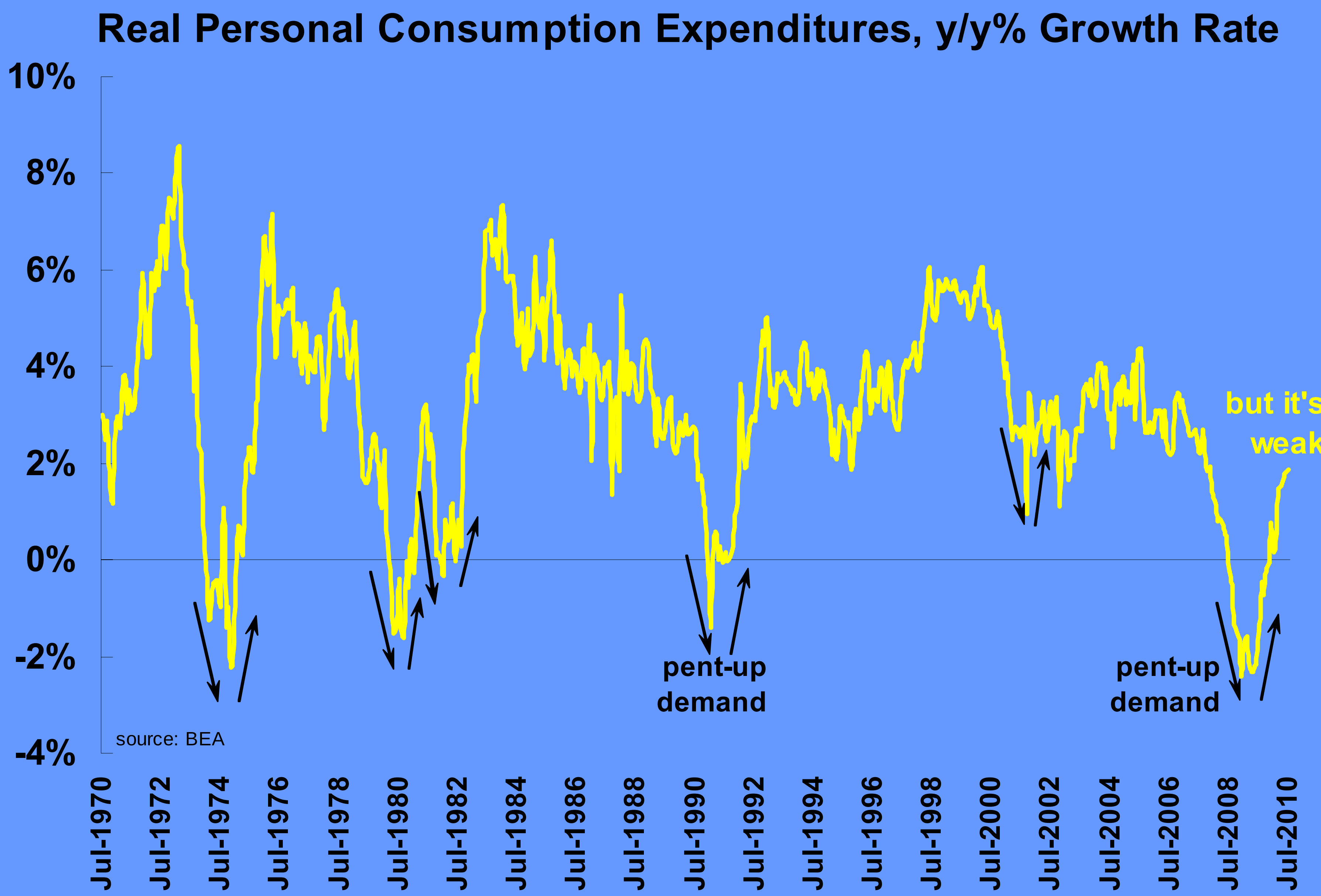


Consumer



Real Personal Consumption Expenditures, y/y% Growth Rate
10%
8%
6%
4%
2%
0%
-2%
-4%
source: BEA
pent-up demand
pent-up demand
Jul-1970
Jul-1972
Jul-1974
Jul-1976
Jul-1978
Jul-1980
Jul-1982
Jul-1984
Jul-1986
Jul-1988
Jul-1990
Jul-1992
Jul-1994
Jul-1996
Jul-1998
Jul-2000
Jul-2002
Jul-2004
Jul-2006
Jul-2008
Jul-2010

Consumer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10%
8%
6%
4%
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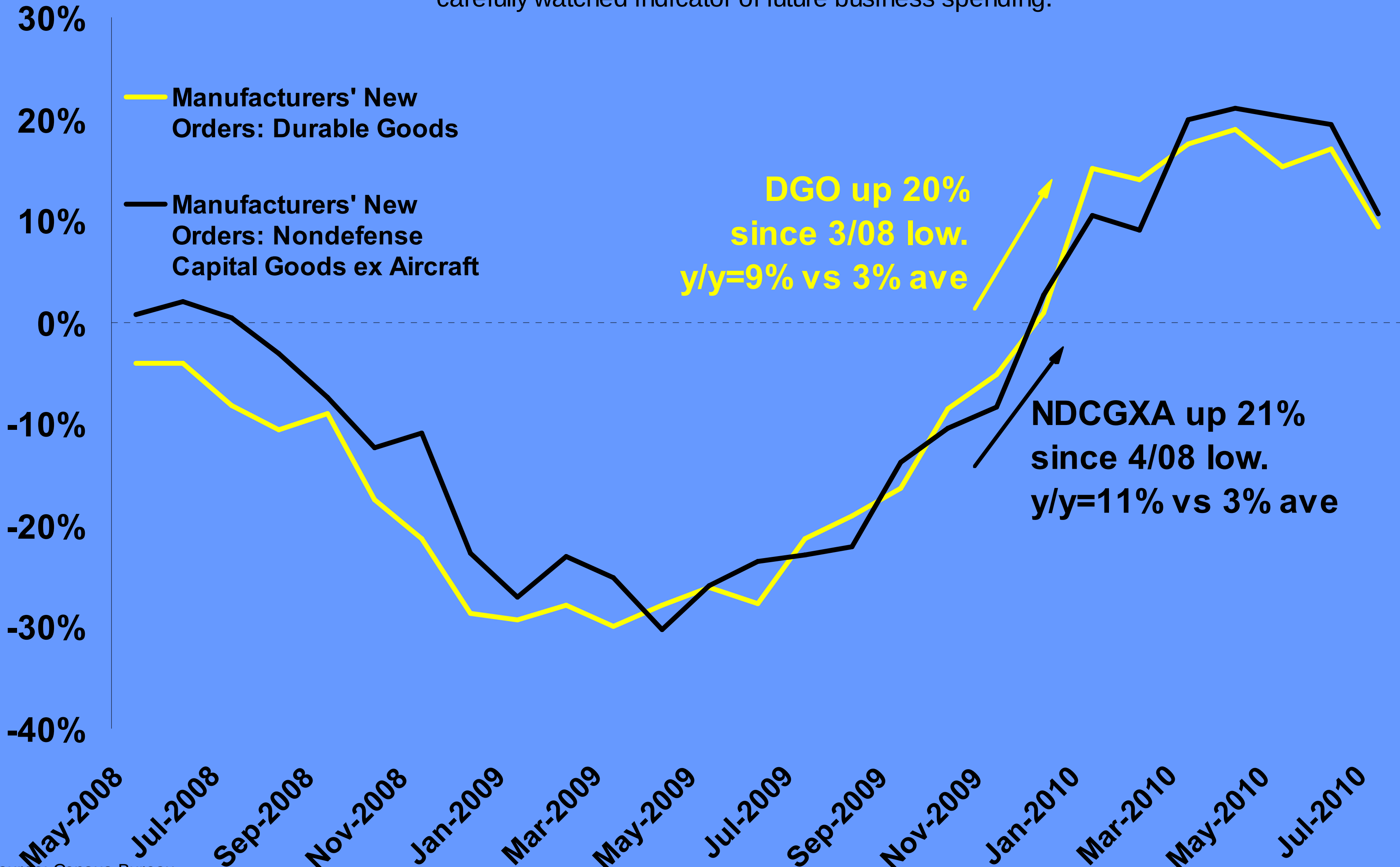
0%
-2%
-4%
source: BEA
pent-up
demand
pent-up
demand
but it's
weak
Jul-1970
Jul-1972
Jul-1974
Jul-1976
Jul-1978
Jul-1980
Jul-1982
Jul-1984
Jul-1986
Jul-1988
Jul-1990
Jul-1992
Jul-1994
Jul-1996
Jul-1998
Jul-2000
Jul-2002
Jul-2004
Jul-2006
Jul-2008
Jul-2010

Durable Goods Orders, y/y % Growth

(note: Manufacturers' New Orders for Nondefense Capital Goods ex Aircraft, is a carefully watched indicator of future business spending.



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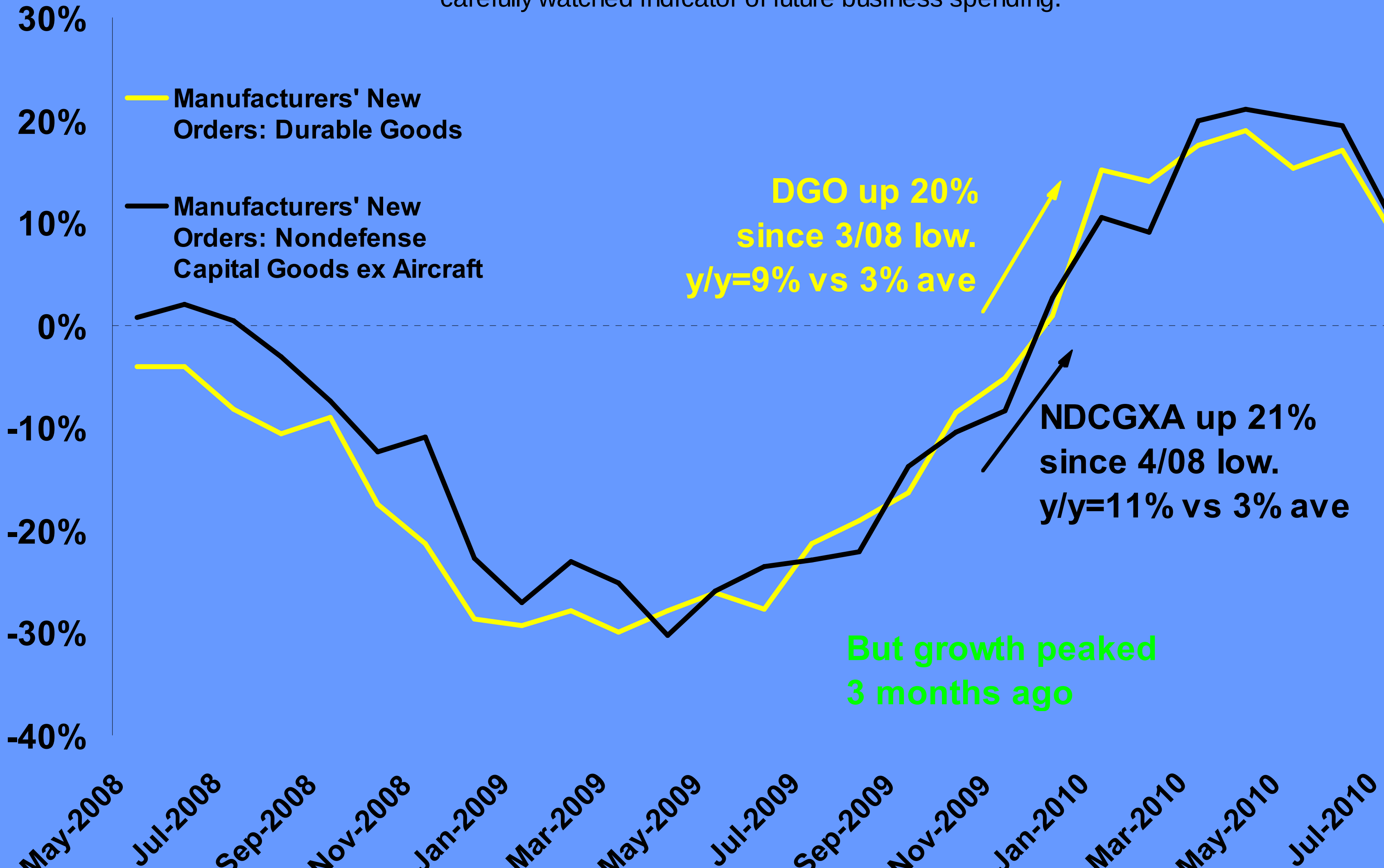

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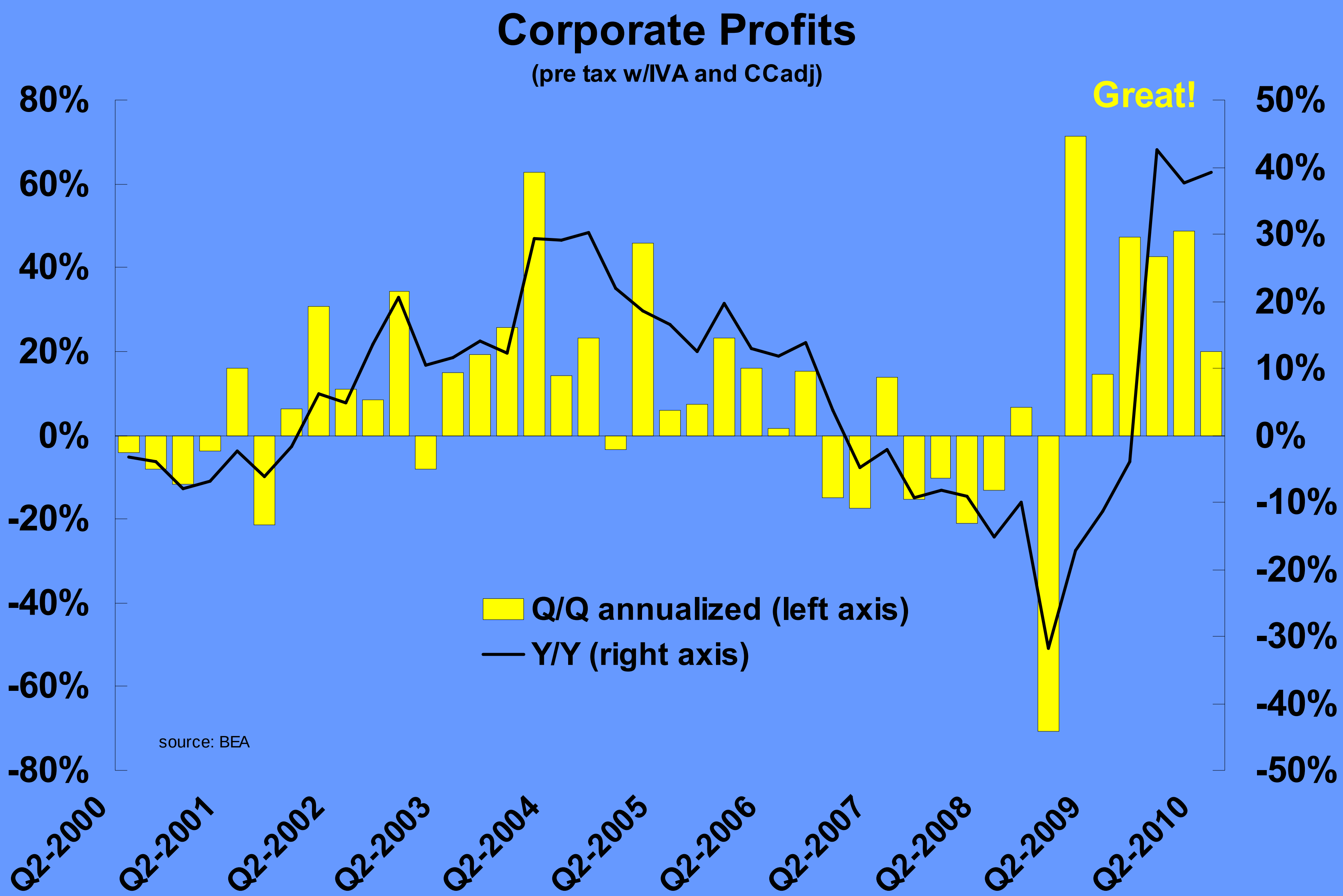
Business conditions good: low interest rates, inflation, labor



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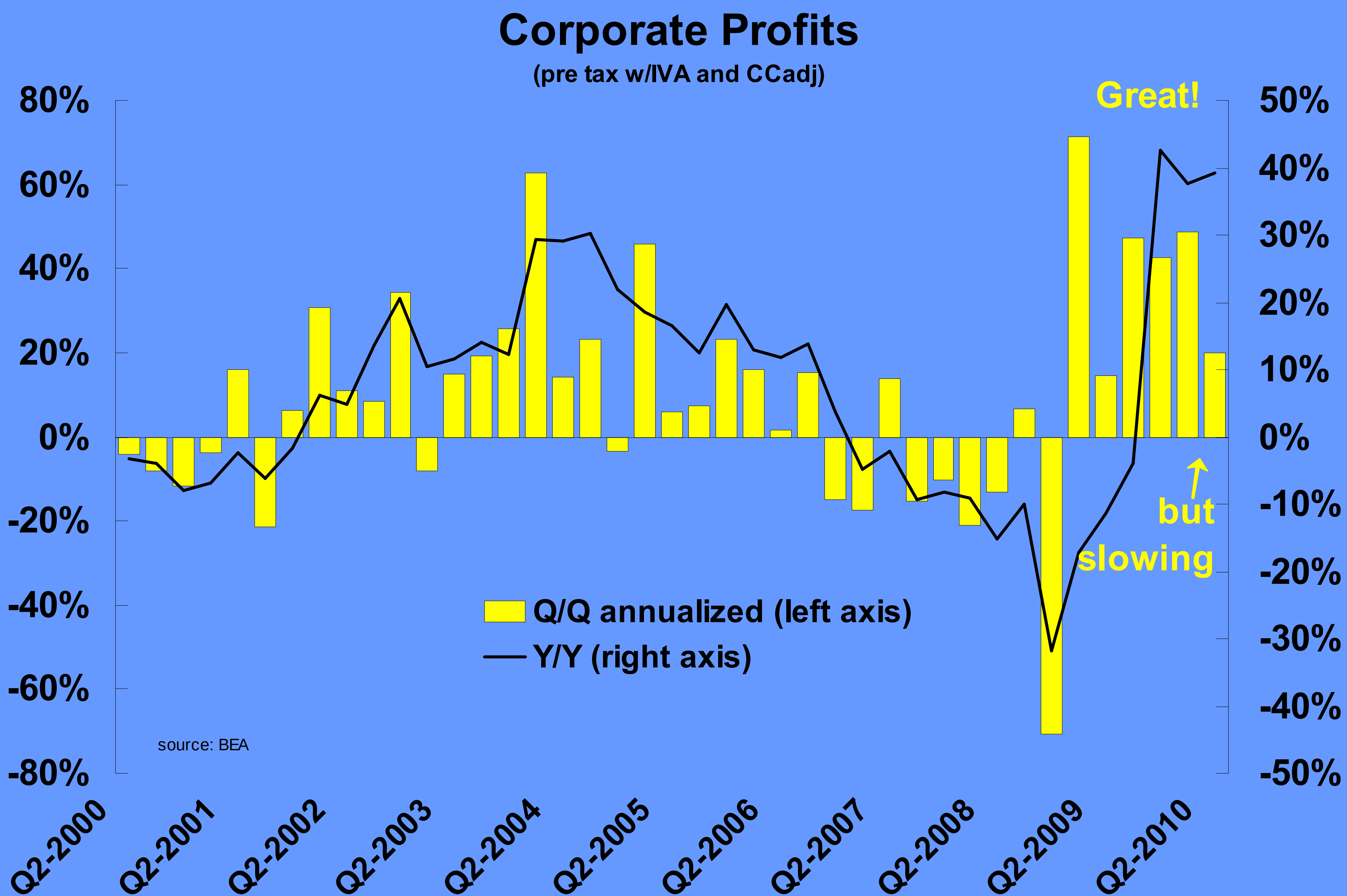
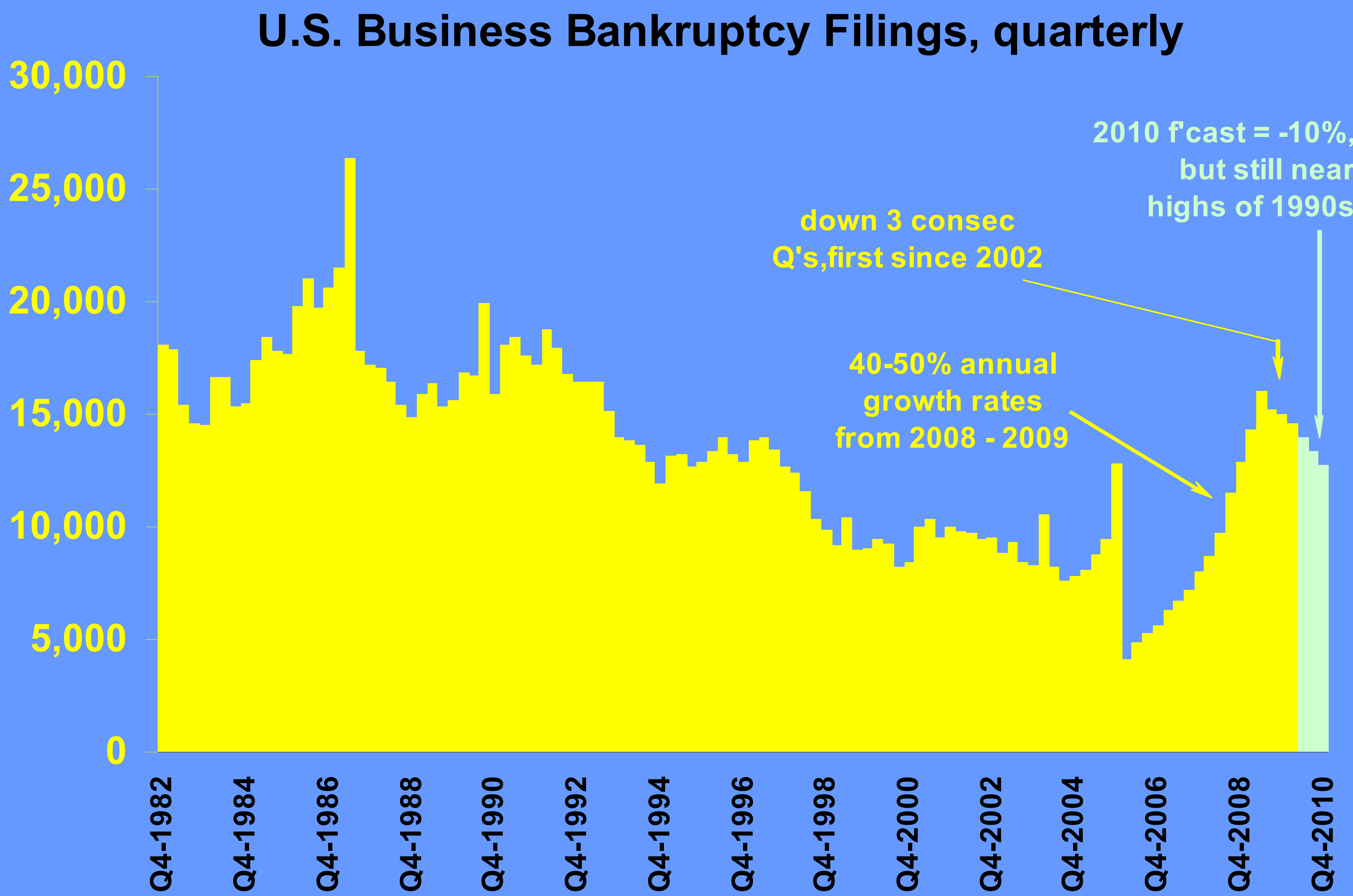


brupts

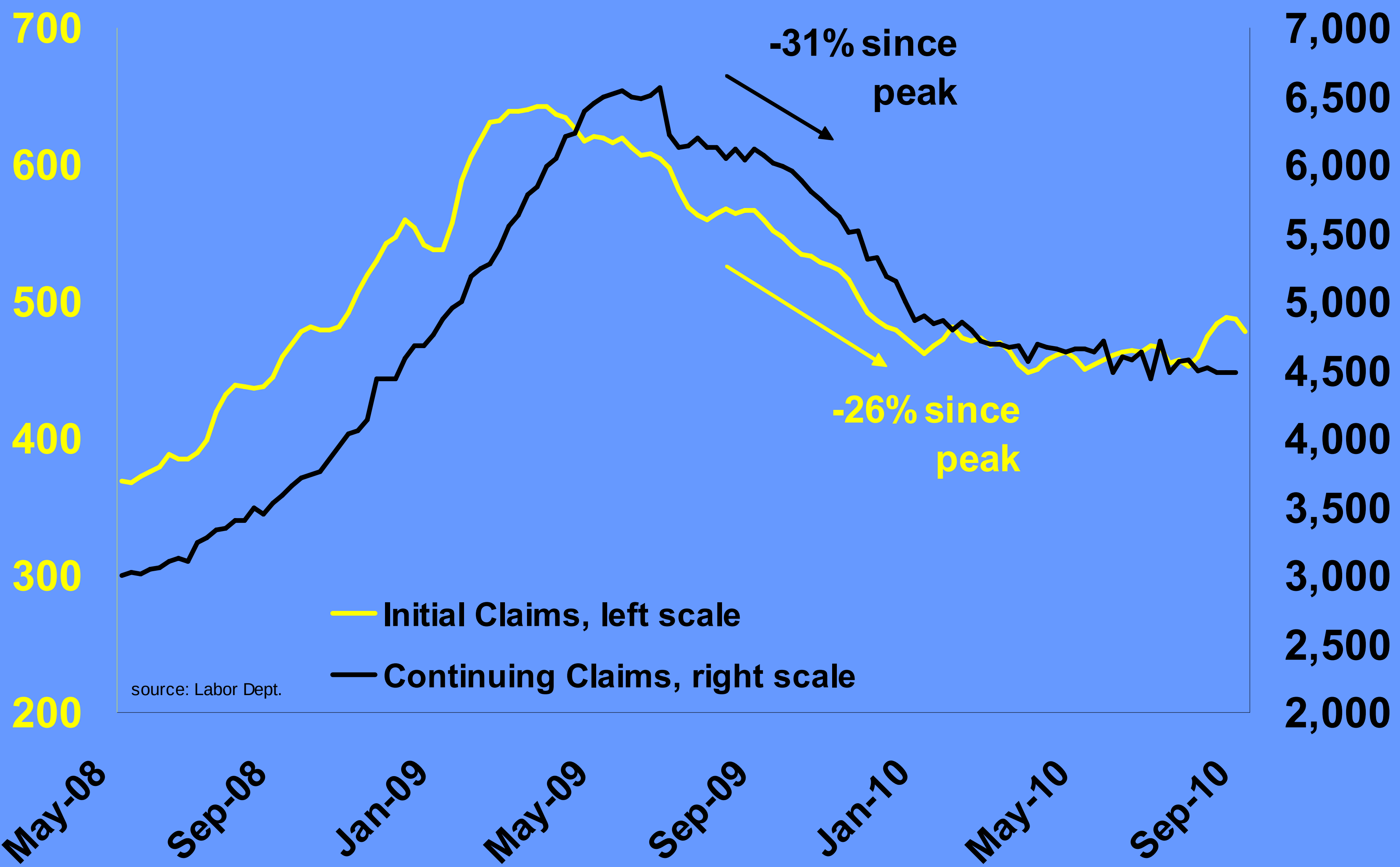
One last measure, Bankruptcies



emply

Employment

Jobless Claims, 000's



Employment

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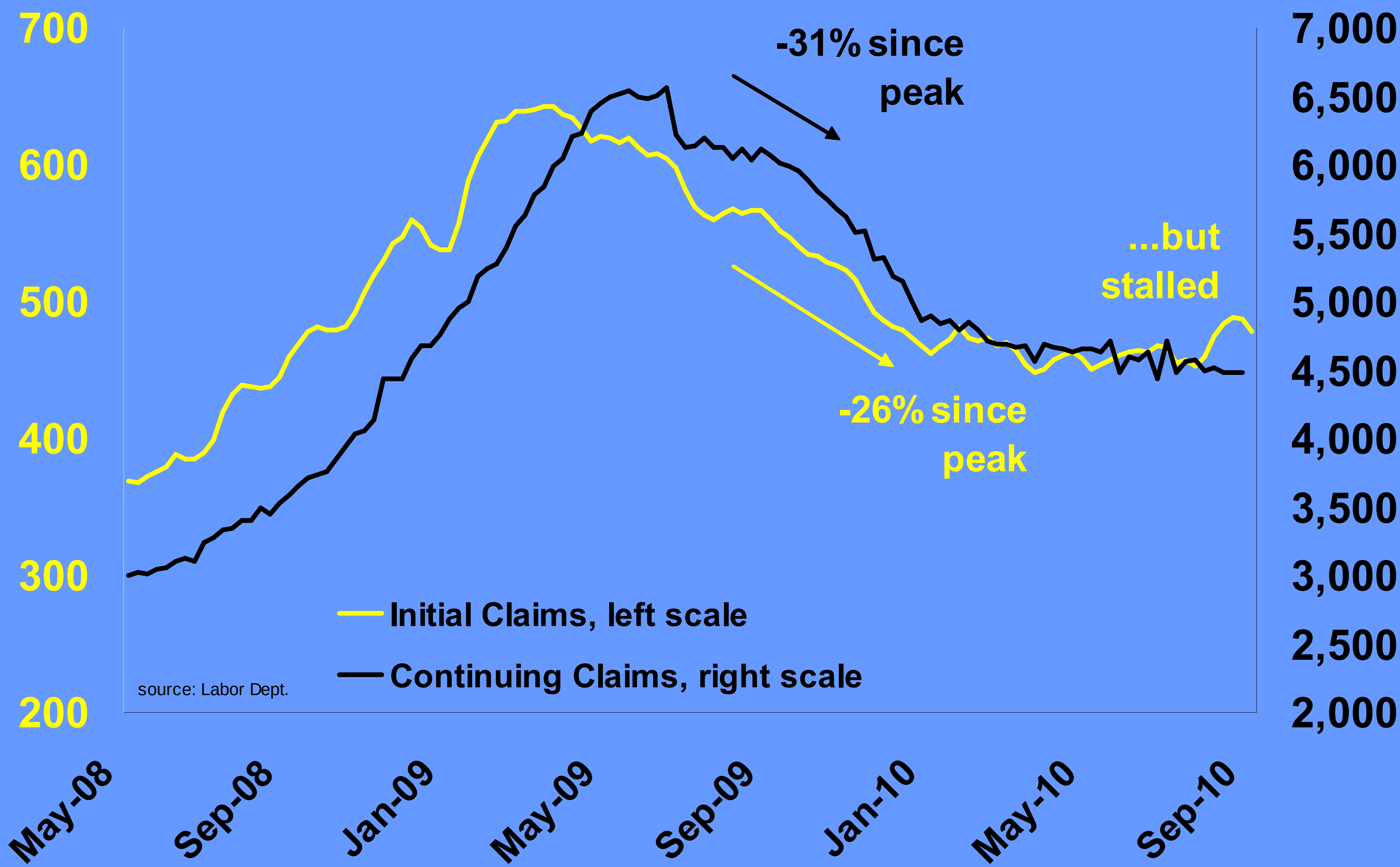
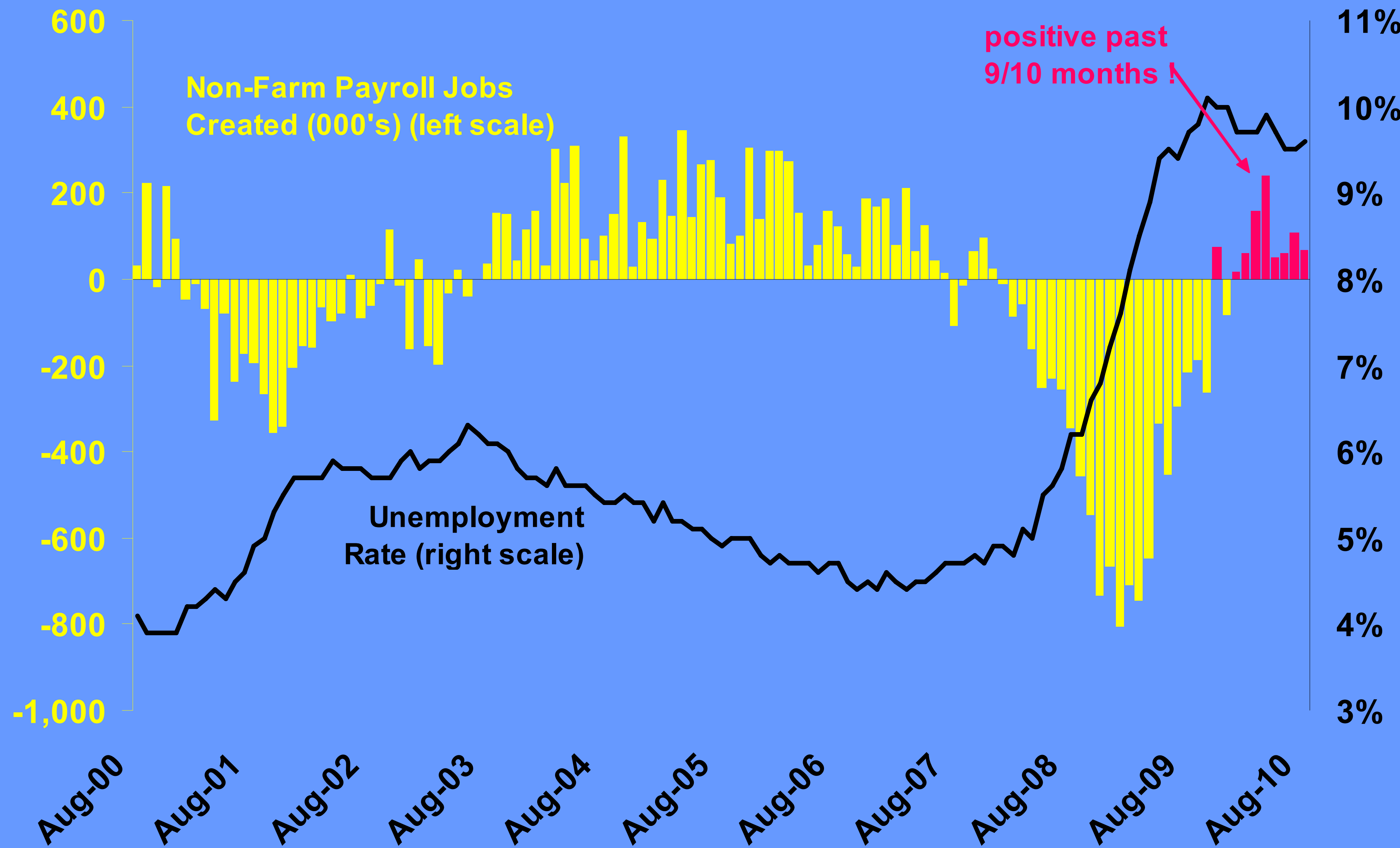


Employment

Private Sector Jobs Created and the Unemployment Rate



source: Labor Department

Employment

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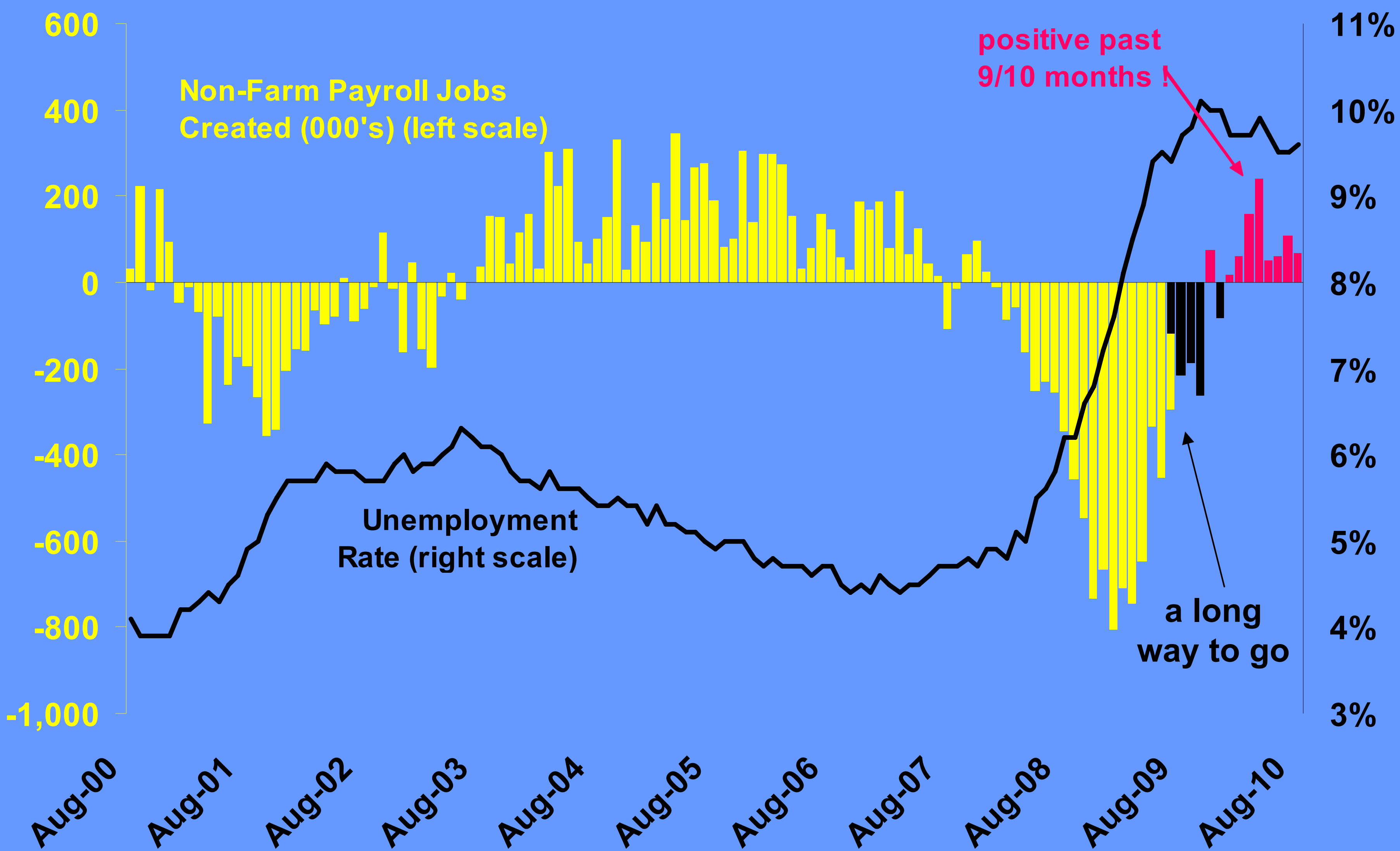

source: Labor Department

Employment

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We are right on the cusp of steady job growth

- The pattern, and the trend, are right
- Weekly jobless claims approaching 450k level which would indicate job growth
- ISM employment index now >50
- Unemployment peaked at 10.1% in Oct, now 9.6%-temp. gets worse as unemployed job seekers re-enter job force
- 9/10 mos. had positive job growth

Recap

- 4 forces caused recession, now helping recovery
- Consumer, manufacturing, and most indicators positive but slowing
- Employment lagging but getting better
- So what's the holdup?

Structuralists:

Too much taxes, regulation, uncertainty make business reluctant to expand (showed evidence)

Keynsians:

Demand too weak, stimulate, spend, then tax (questionable results)

Either way…

Arguments for double-dip / deflation or continued slow growth / inflation

Double dip / deflation

- Monetary policy ineffective
- Fiscal policy damaging
- Shaky housing market
- High unemployment
- Taxes and regulation
- Weak consumer

Slow growth / inflation

- Monetary policy set to “nuclear”
- Banks wanting to lend
- Low inflation, interest rates, labor rates (now)
- High corporate profits
- Big increase in M&A
- Rest of the world growing
- Change in WDC, fiscal policy coming
- Yield Curve very positive (leads 3-5 quarters)

On to inflation…

INFLATION

Inflation

Simple example

Today:
Lend $1 @10%. Loaf of Bread costs $1

Inflation goes to 20%

A Year later:
Creditor gets $1.10 back.
But now loaf of bread costs $1.20.

Creditors lose.
Debtors like the U.S. government, win.
The U.S. government will <u>want</u> inflation.

1-2 years down the road

Inflation

Several types of inflation:

- Consumer price inflation - bread
- Money price inflation - interest rates
- Commodity price inflation - oil
- Asset price inflation - stocks, houses
- Government policies can contribute to inflation

Monetary policy (Takes 3-5 Q's to work!)

- **Run by the Fed, Bernanke**
- **Interest rates, money, QE**

Fiscal Policy

- **Run by the administration and Congress**
- **Taxes and spending**

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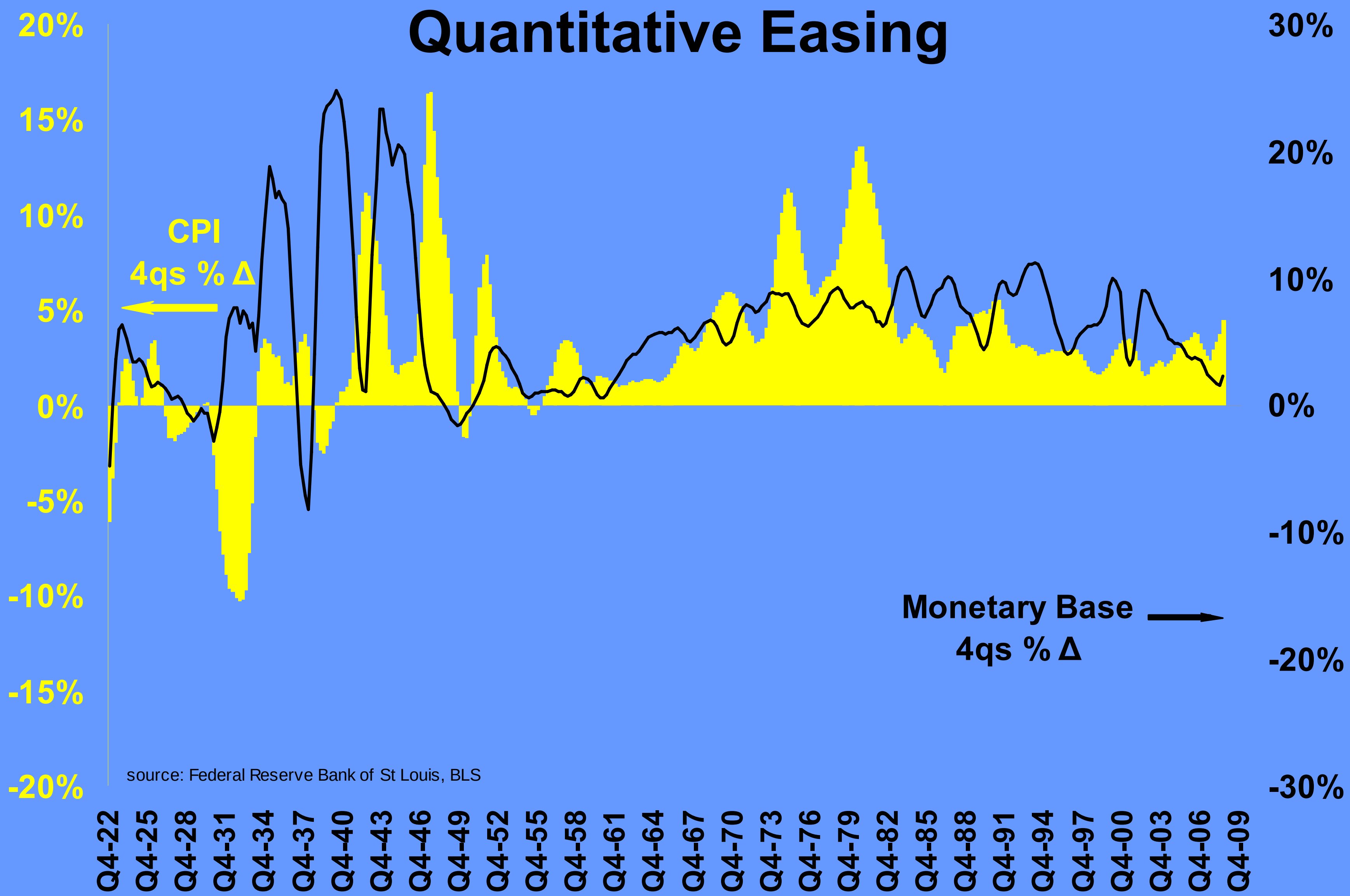
Monetary Base: Printing Money, Quantitative Easing



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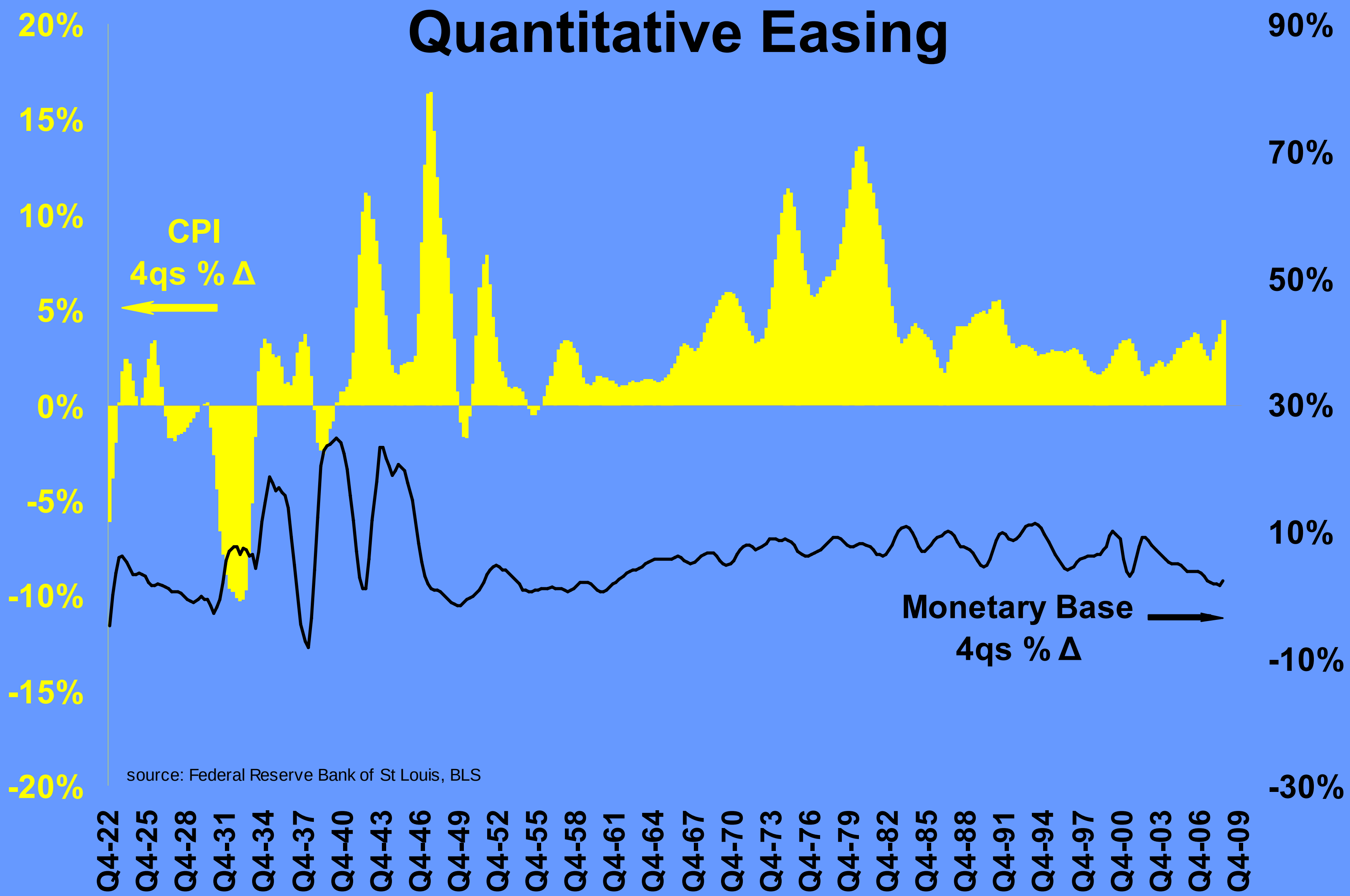

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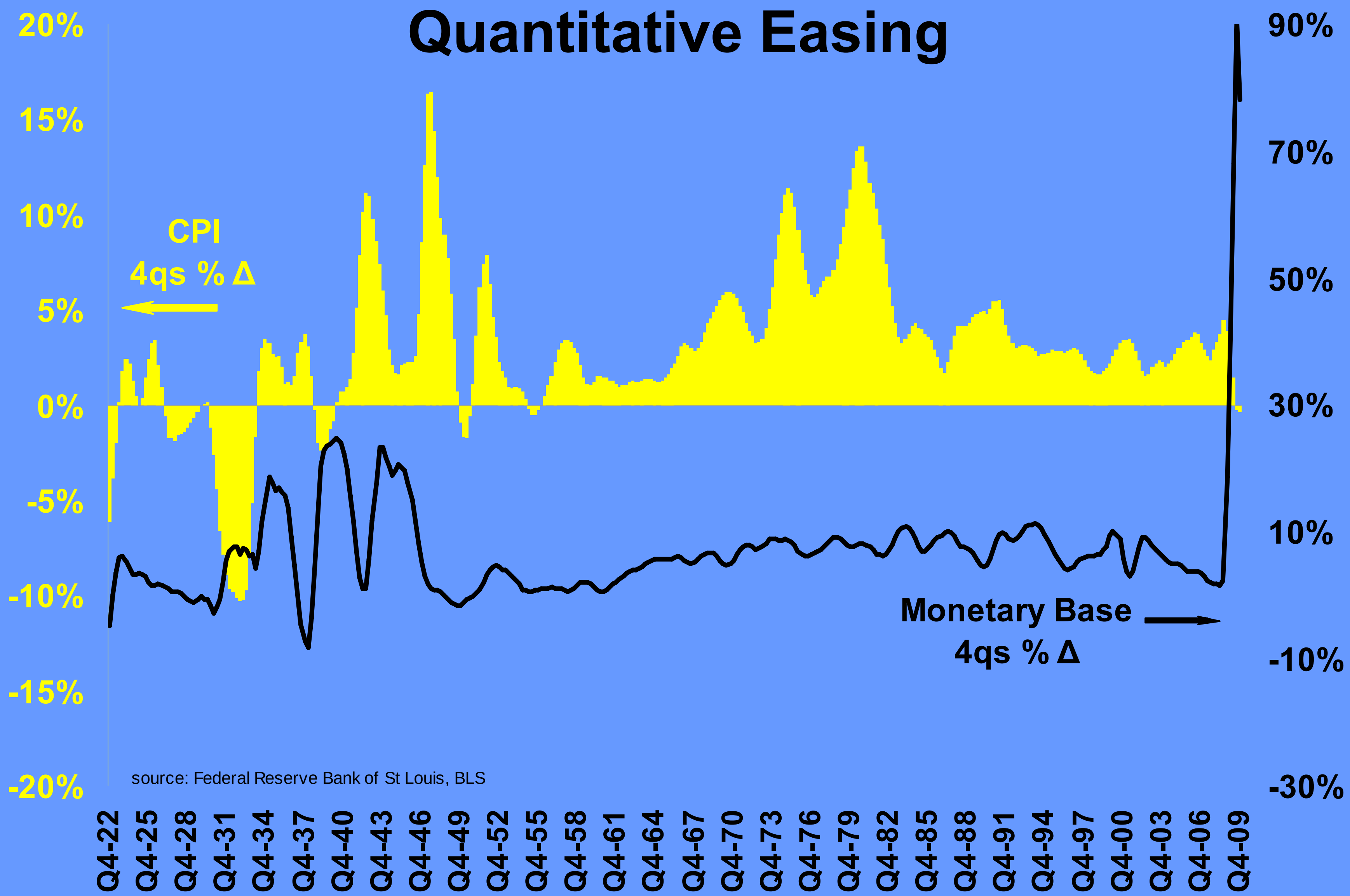

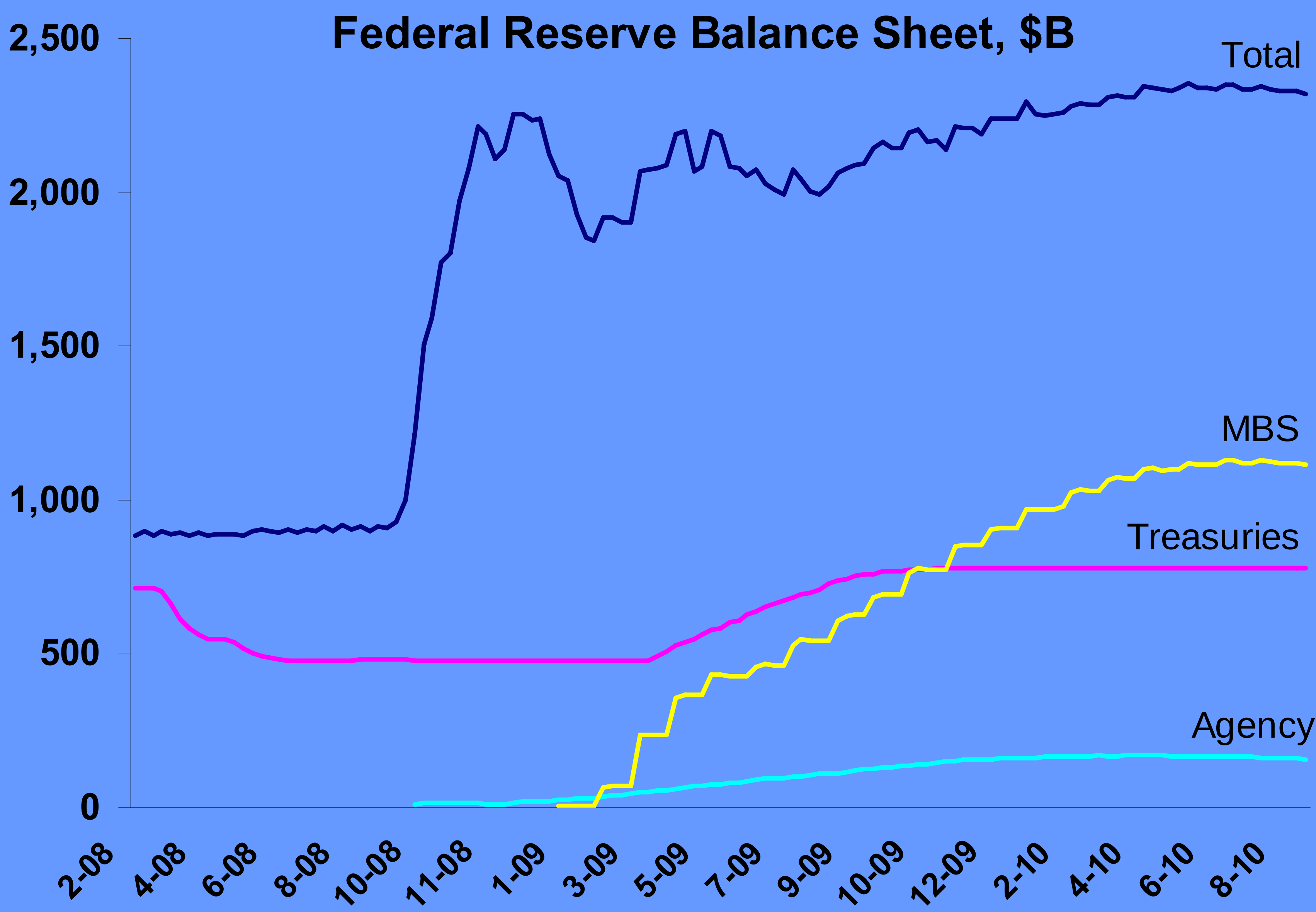
Federal Reserve Balance Sheet, $B
2,500
2,000
1,500
1,000
500
0
Total
MBS
Treasuries
Agency
2-08
4-08
6-08
8-08
10-08
11-08
1-09
3-09
5-09
7-09
9-09
10-09
12-09
2-10
4-10
6-10
8-10

Fed not

The Fed will reverse all that, because, here's what happens if you print a bit too much money:

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3

German Hyperinflation

Wholesale Price Index

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Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6

German Hyperinflation

Wholesale Price Index

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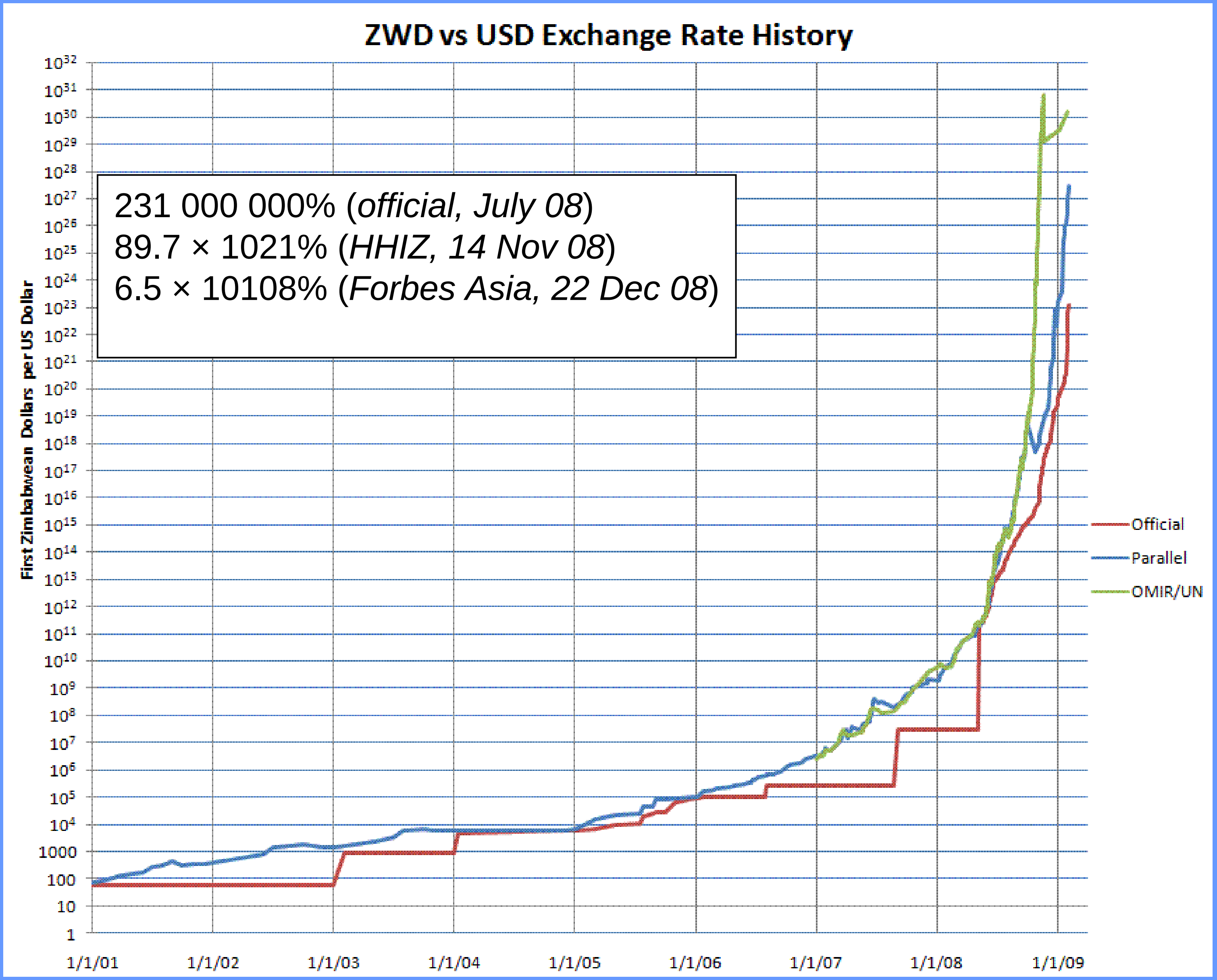
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6
Jan 1923	2,785
July 1923	194,000
Nov 1923	726,000,000,000

Zimbabwean Hyperinflation



$250,000,000

The Fed is unlikely to let that happen.

So change in balance sheet and public statements wil start to signal gently that it WILL have to come

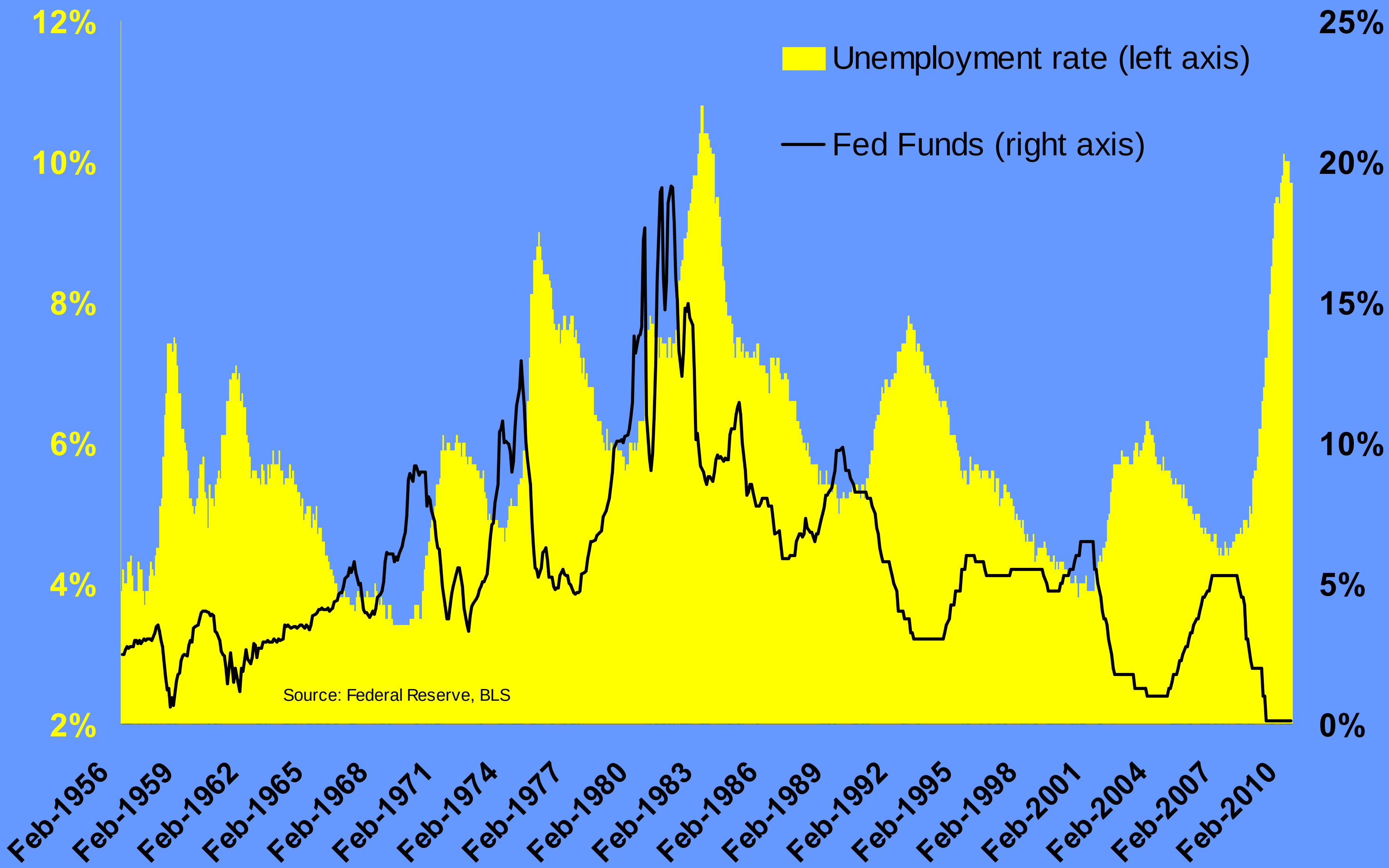
"But there's no sign of inflation and unemployment's high!"

Of course there isn't! That's not the point!

The point is that inflation gets out of hand easily, and it takes a really long time for changes in monetary policy to have full effect; 3-5 Qs.

First note that unemployment peaks around 1-2 Qs after recession ends.. about right.. June – October.. important

Federal Funds Rate vs Unemployment



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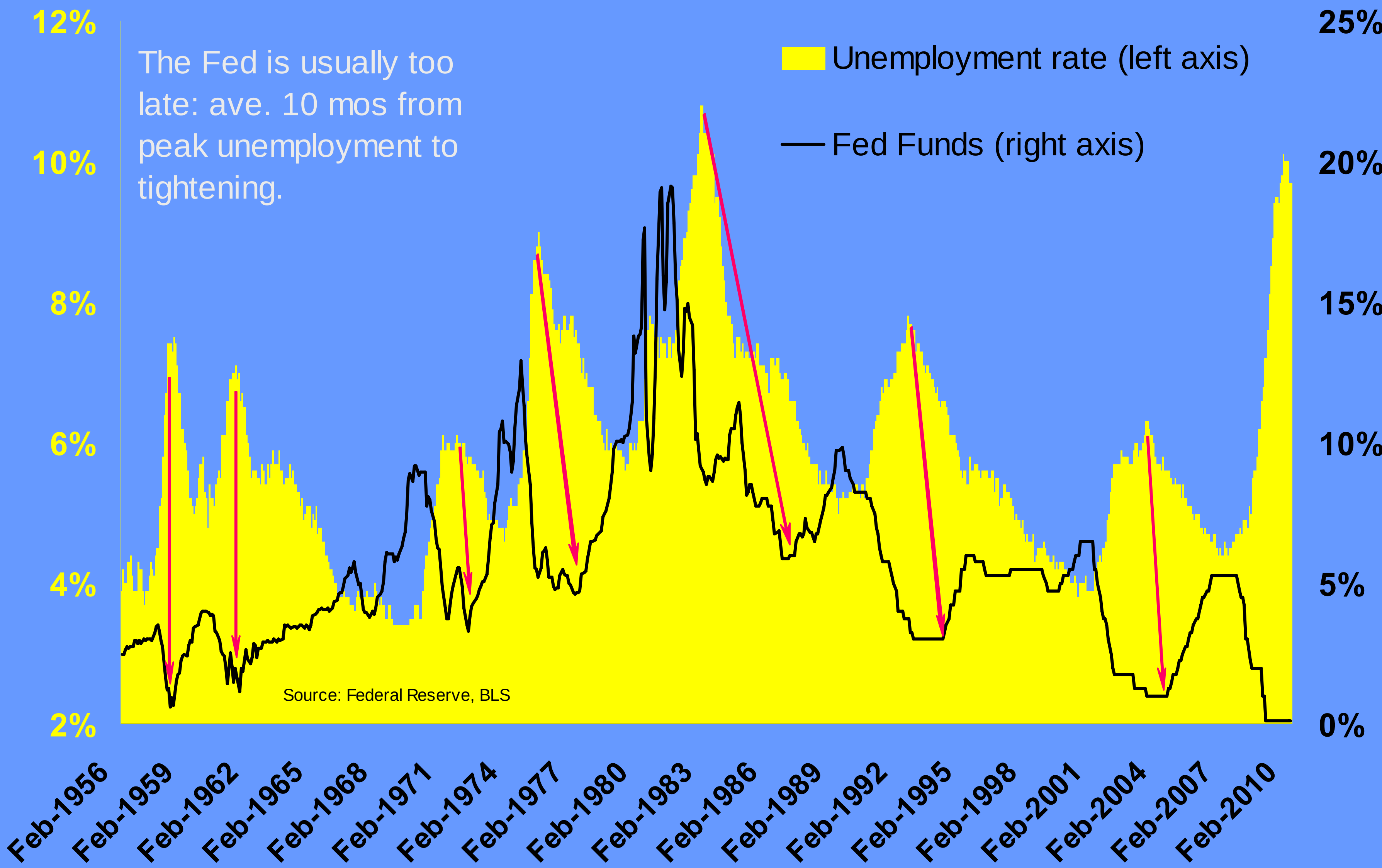
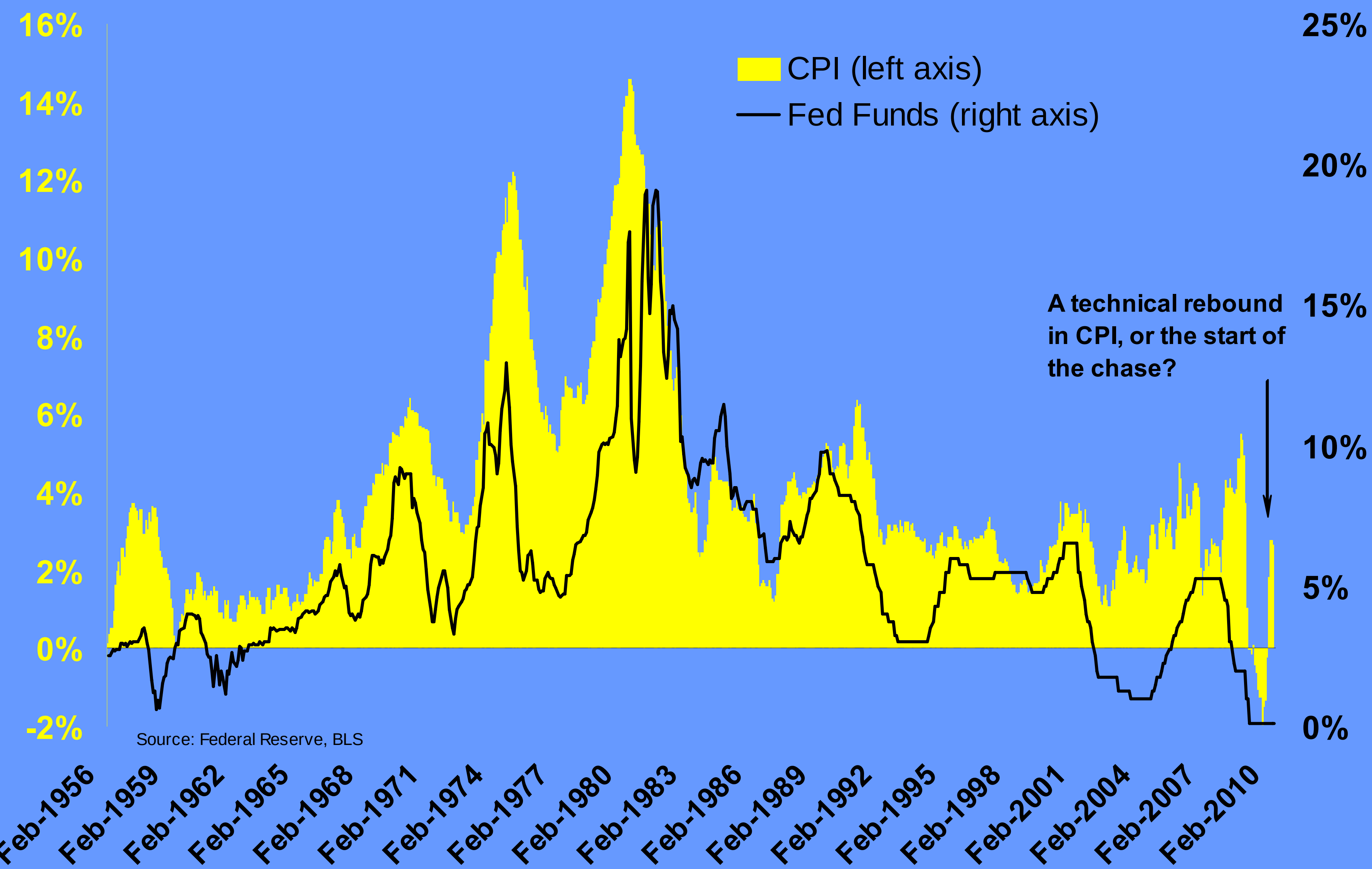


Federal Funds Rate vs Inflation



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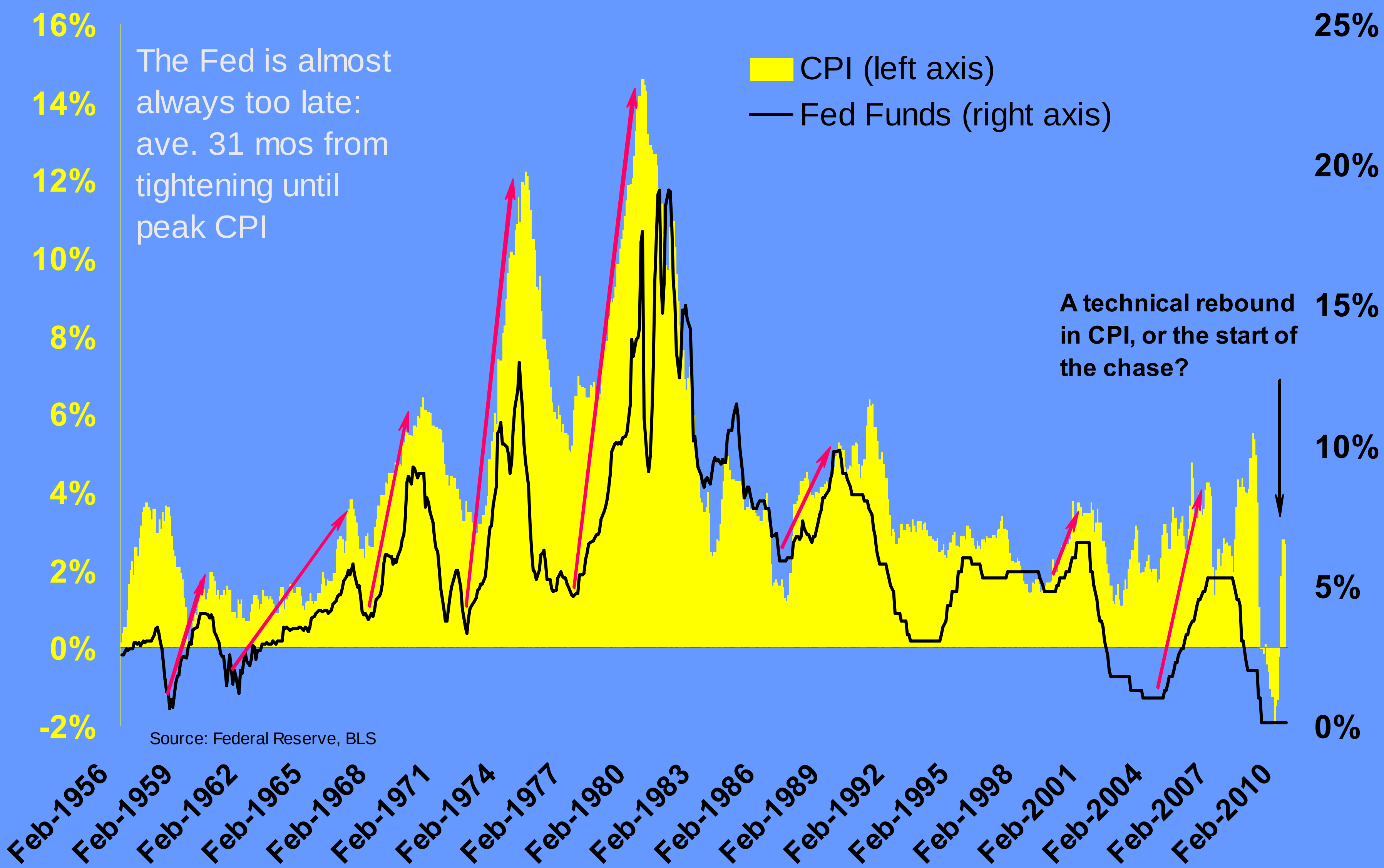


Fiscal Policy

The Federal Reserve Bank at least has a plan to reduce spending and mop up liquidity (or do the opposite). Little debate over policy so far.

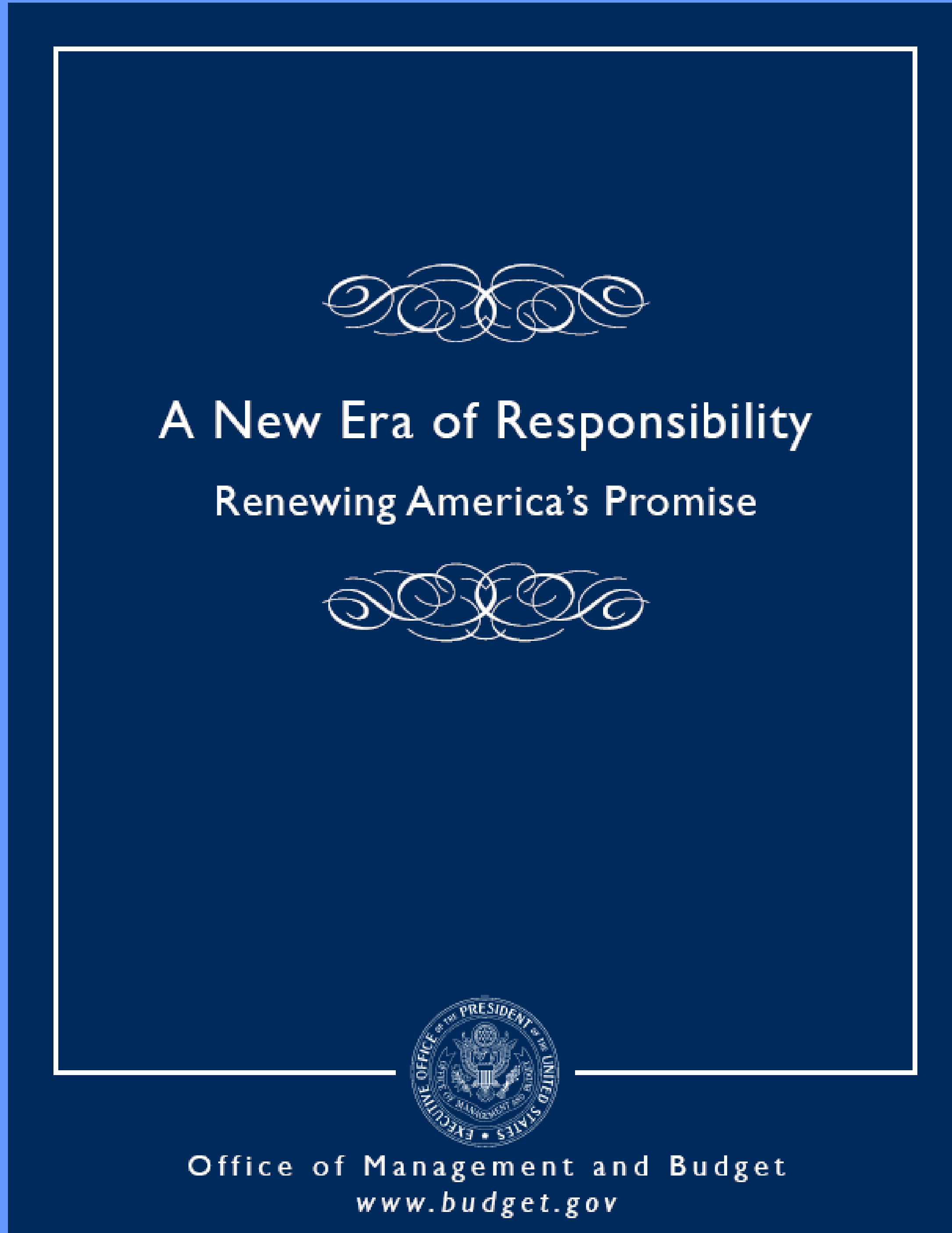
The Federal Reserve Bank at least has a plan to reduce spending and mop up liquidity.

The Federal Government's plan is to spend <u>more</u>, to effectively <u>increase</u> liquidity, and to <u>increase</u> the debt burden.

Spending, Deficits and Debt

Gov't spends	$120
Gov't gets tax revenue	$100
Deficit	$20

- Treas. gets loan, issues $20 notes/bonds
- Not a Ponzi scheme, no intent to deceive, return is fixed, debt retired, revolving credit


A New Era of Responsibility

Renewing America's Promise

Office of Management and Budget
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Budget

of the U. S. Government

Fiscal Year 2011

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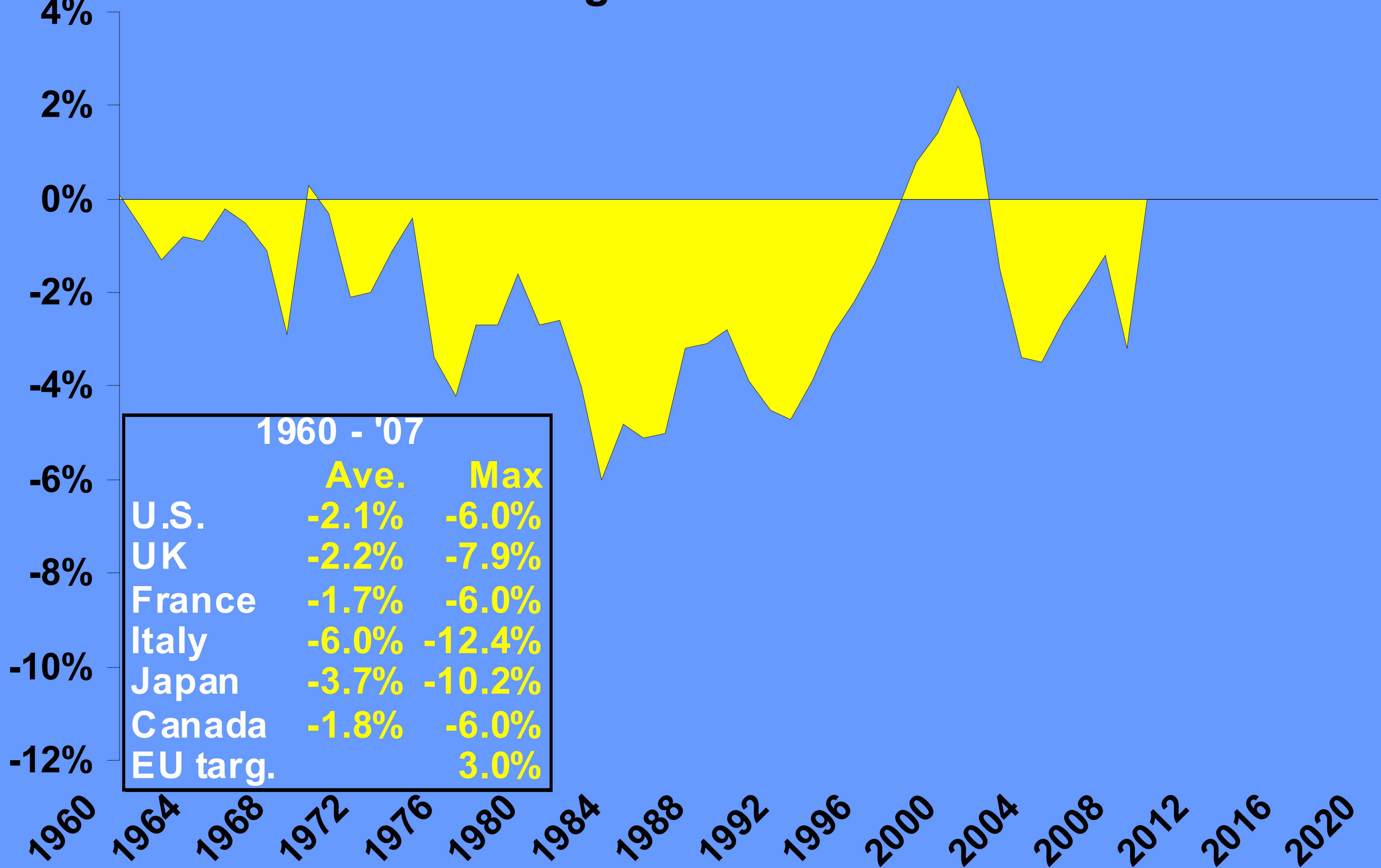
Federal Budget Deficit as a % of GDP



1960 - '07	Ave.	Max
U.S.	-2.1%	-6.0%
UK	-2.2%	-7.9%
France	-1.7%	-6.0%
Italy	-6.0%	-12.4%
Japan	-3.7%	-10.2%
Canada	-1.8%	-6.0%
EU targ.		3.0%

Sources: The Federal Reserve. Congressional Budget Office

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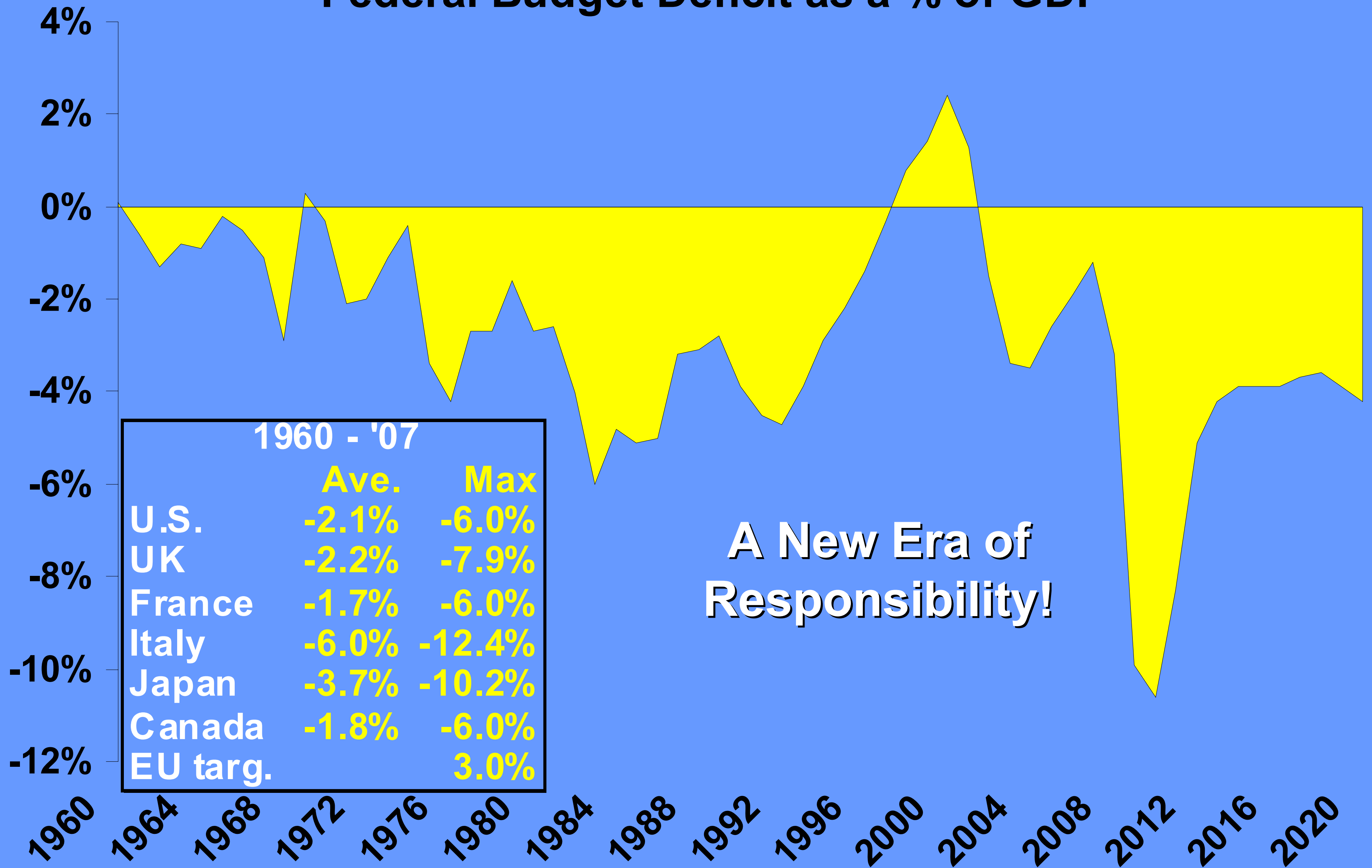

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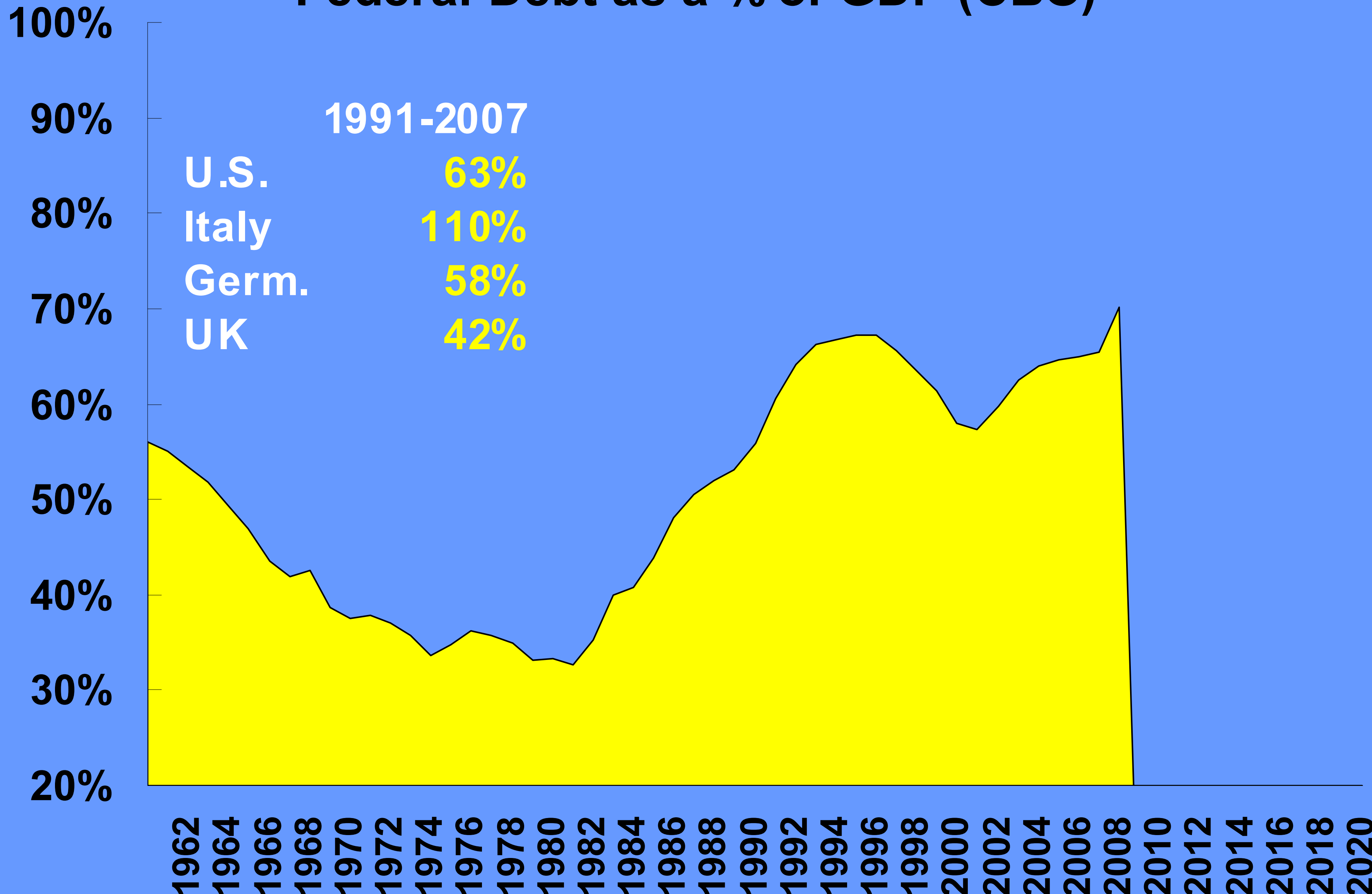
Sources: The Federal Reserve. Congressional Budget Office

Federal Debt as a % of GDP (CBO)



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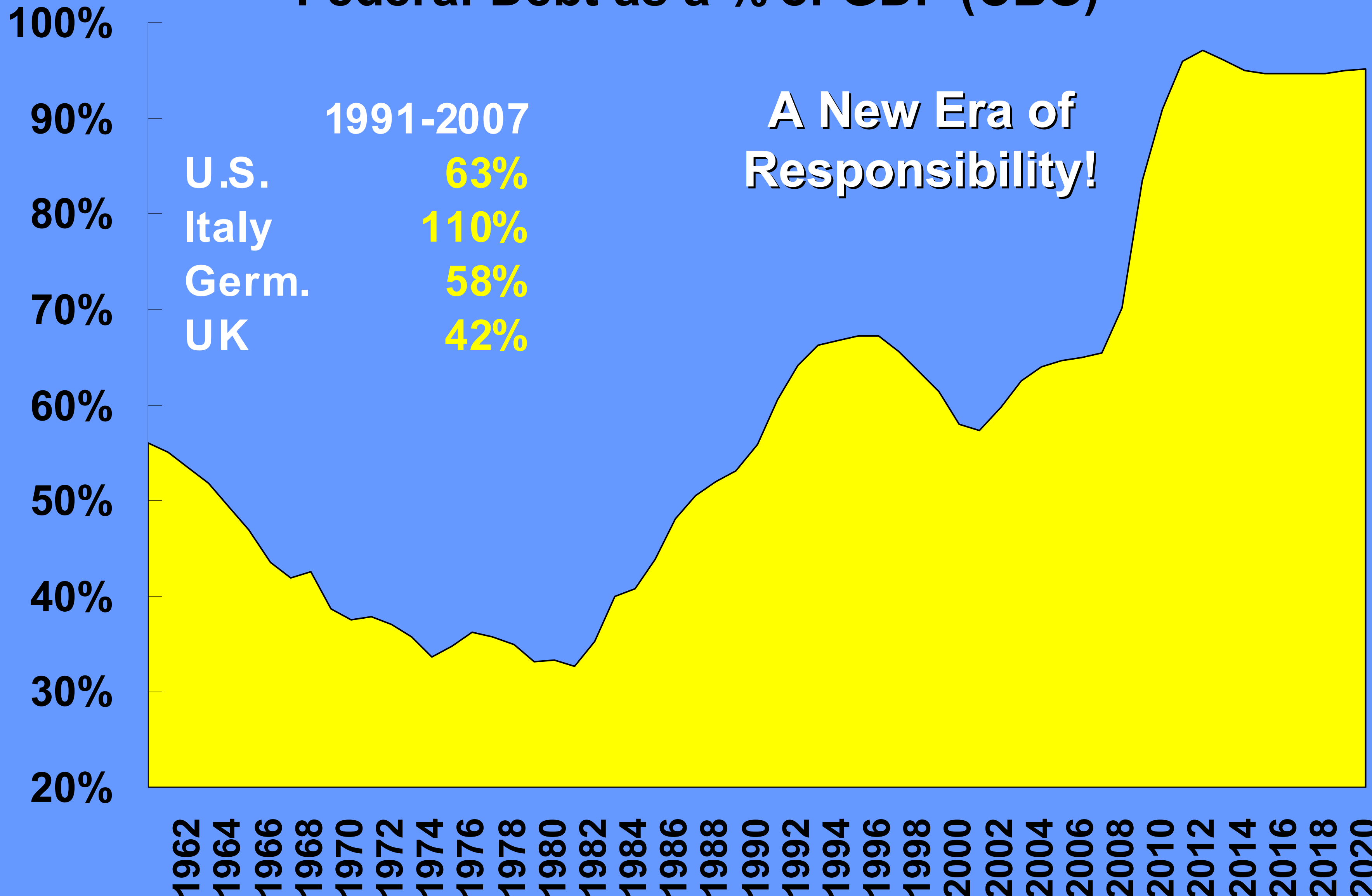

contrib money

Fiscal Stimulus

- $787B stimulus spending: goes into 2011, only 64% has been "spent"
- $150B "Jobs Bill"
- $25B to state govts to prevent layoffs
- Another $65B recently
- Now another $50B in infrastructure spending (not stimulus)

- Congressmen have no apparent understanding of economics, the costs of indebtedness, or that they are committing our children to work for foreign nations to pay the debts, long after they have died.

Fiscal Policy

On Wednesday, September 8th, just a few days ago, the U.S. Treasury borrowed $21 B "on your behalf," for 10 years.

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And it will borrow a similar amount in early October for 10 years.

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And it will borrow a similar amount in early October for 10 years.

About 10% of this amount will be borrowed from the Chinese (and another 10% from the Japanese)

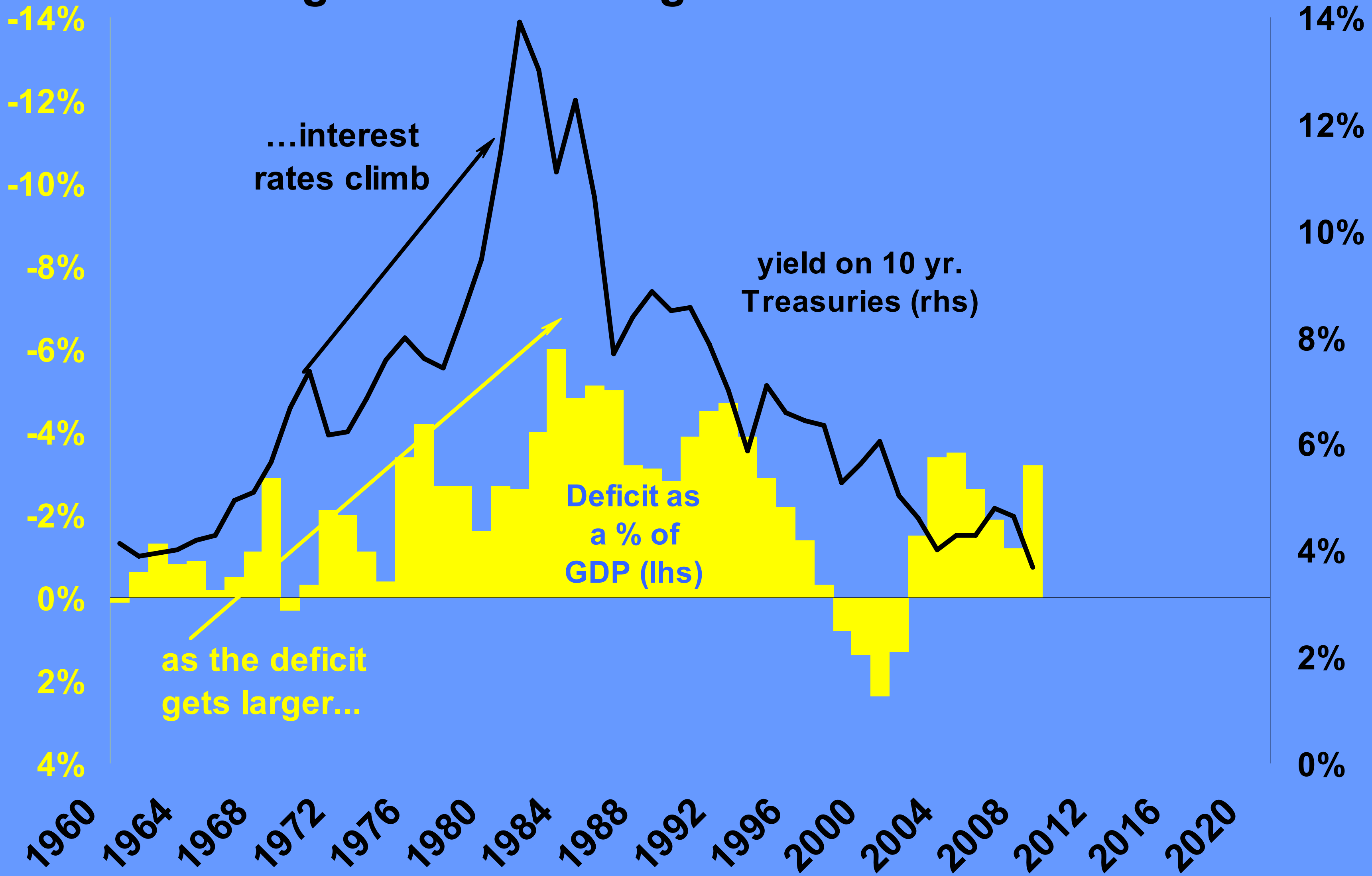
In 10 years my kids, and yours, will be paying taxes to repay those loans to the Chinese.

Recent Treasury Issuance, $B

	10 yr	30 yr	All (net)
Jan-09	16	0	29
Feb-09	21	14	81
Mar-09	18	11	204
Apr-09	18	0	134
May-09	22	14	19
Jun-09	19	11	218
Jul-09	19	11	155
Aug-09	23	15	104
Sep-09	20	12	147
Oct-09	20	12	71
Nov-09	25	16	235
Dec-09	21	13	154
Jan-10	21	13	58
Feb-10	25	16	134
Mar-10	21	13	242
Apr-10	21	13	140
May-10	24	16	15
Jun-10	21	13	250
Jul-10	21	13	68
Aug-10	24	16	79

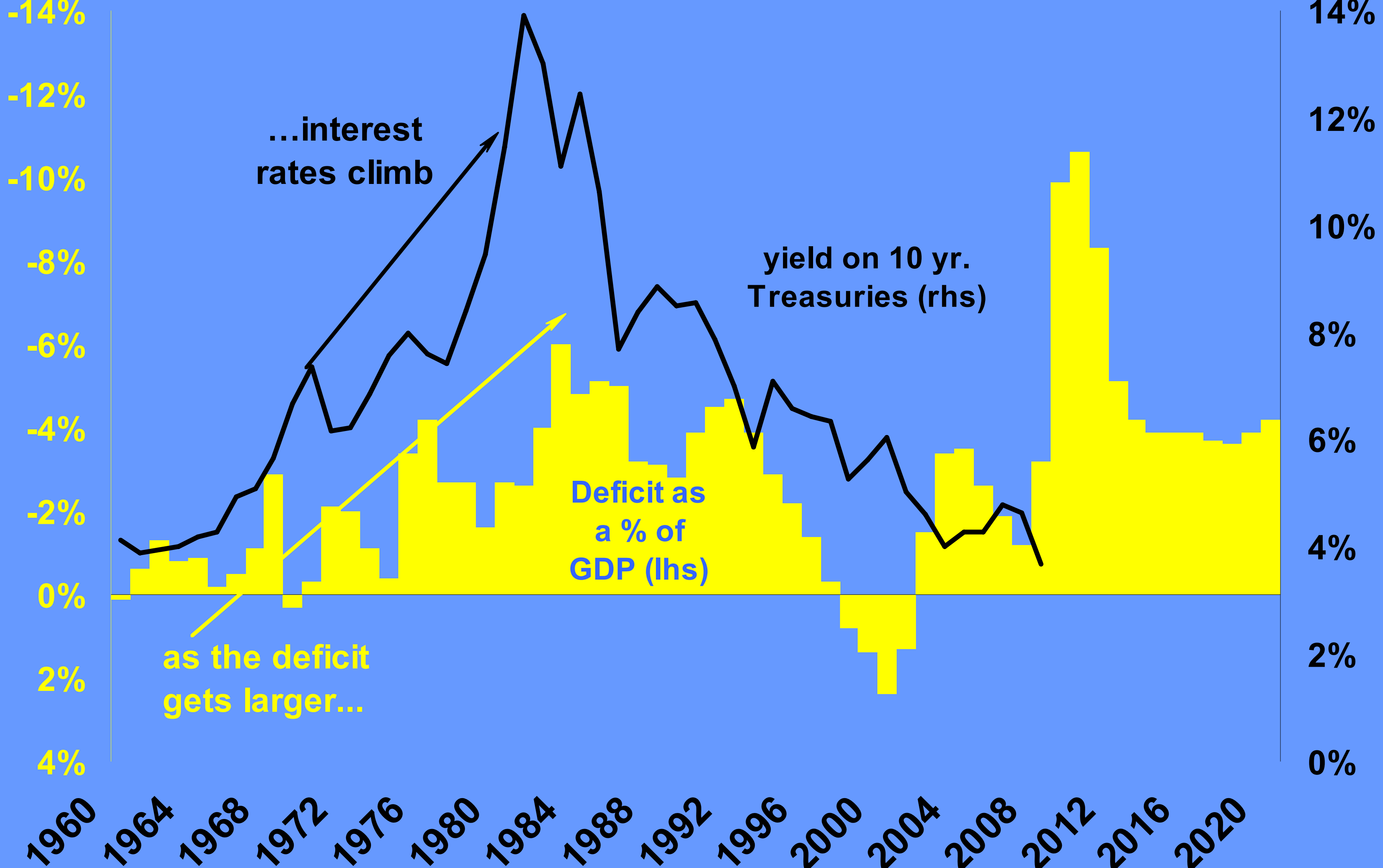
- **Deficit will contribute to Inflation of Consumer Prices**
- **And will really contribute to Inflation of Money Prices; Interest Rates**

"Crowding Out:" The Budget Deficit vs. Interest Rates



Sources: The Federal Reserve. Congressional Budget Office

"Crowding Out:" The Budget Deficit vs. Interest Rates



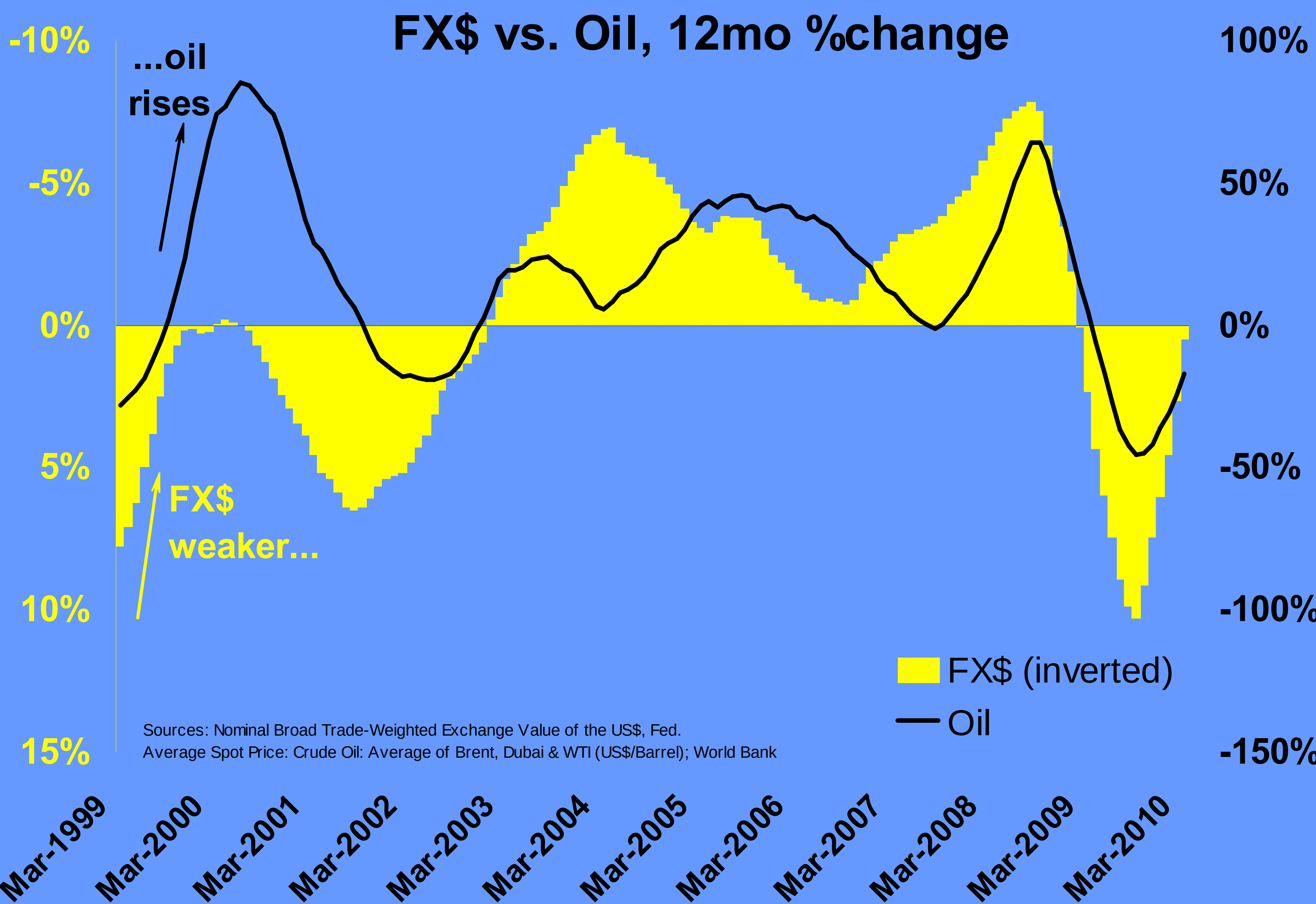
Sources: The Federal Reserve. Congressional Budget Office

Deficits

• Do usually cause money price inflation (interest rates) as just shown

• In this case, massive deficits also likely to cause FX$ inflation – “weak” $...

• Which will lead to commodity, particularly OIL price inflation


FX$ vs. Oil, 12mo %change
-10%
-5%
0%
5%
10%
15%
100%
50%
0%
-50%
-100%
-150%
...oil rises
FX$ weaker...
FX$ (inverted)
Oil
Sources: Nominal Broad Trade-Weighted Exchange Value of the US$, Fed.
Average Spot Price: Crude Oil: Average of Brent, Dubai & WTI (US$/Barrel); World Bank
Mar-1999
Mar-2000
Mar-2001
Mar-2002
Mar-2003
Mar-2004
Mar-2005
Mar-2006
Mar-2007
Mar-2008
Mar-2009
Mar-2010

- So we’ve seen consumer, interest rate, and commodity inflation.

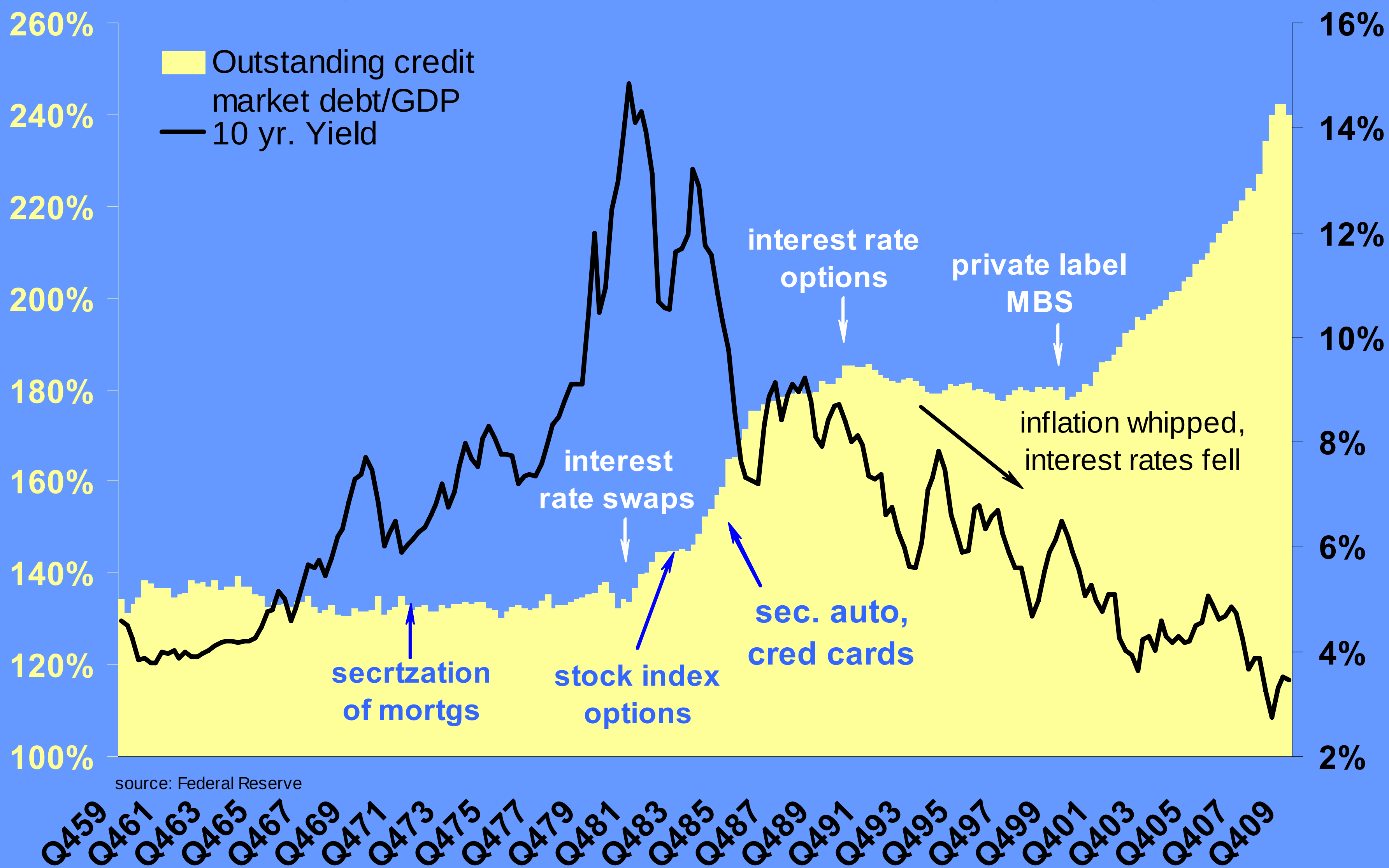
- Final Form of Inflation: Bubbles

- How did that mess just happen?

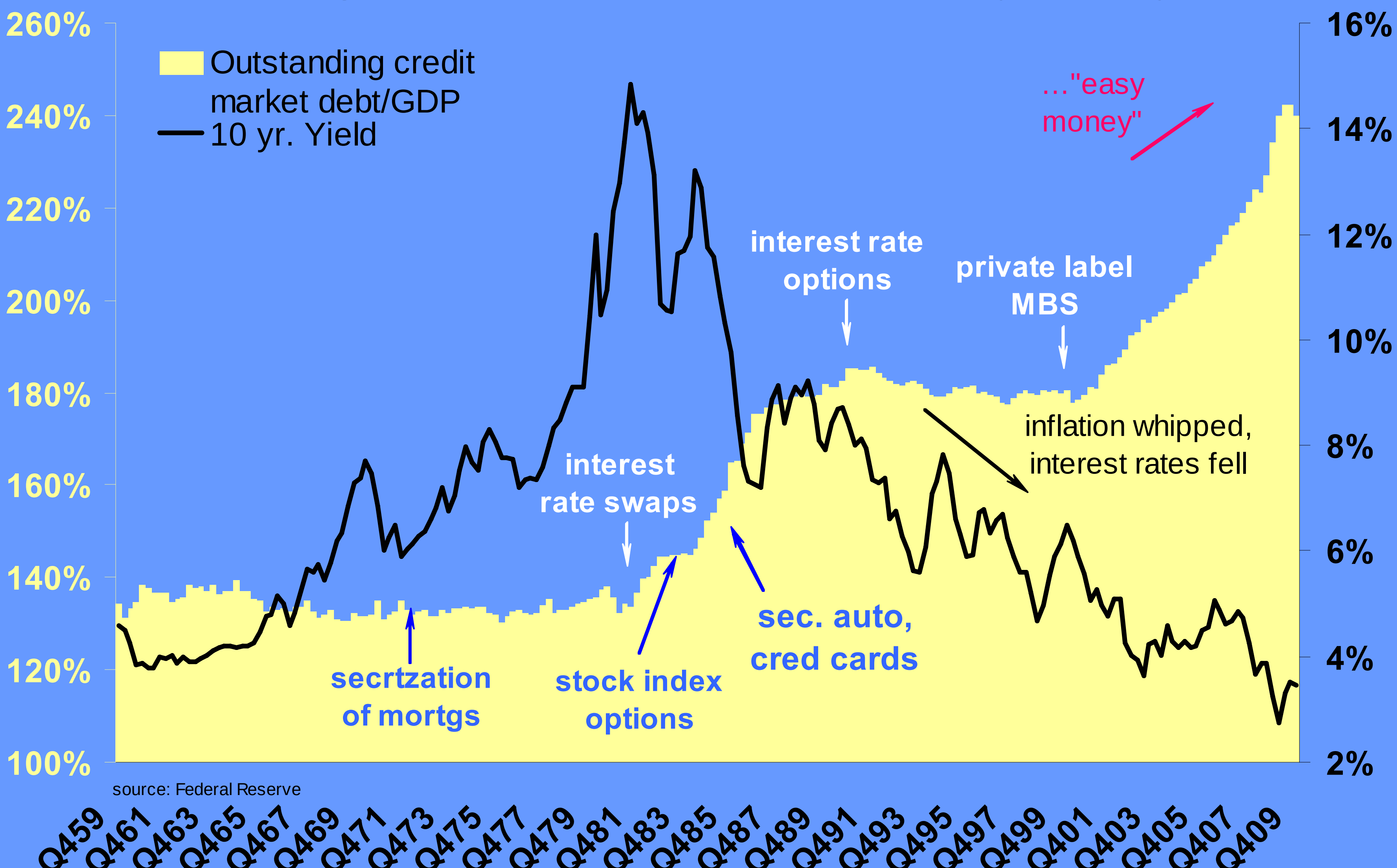
- How did that bubble form?

- How about the one before that?
    - (and China now, and Australia now)

The Big Picture; the Evolution of Easy Money



The Big Picture; the Evolution of Easy Money



source: Federal Reserve

But really, who's to blame for the financial crisis?

EULER HERMES Business insured. Success ensured.

- Community Reinvestment Act for promoting risky loans
- Mortgage bankers and brokers for making those loans
- People for taking those loans when they shouldn't have
- Fannie / Freddie for providing a market for those loans
- Rating Agencies for being lulled
- Regulators for not paying attention
- Foreigners for lending us too much money
- Investors for creating too much "spec" housing
- Investors for seeking too much risk in MBS

But really, who's to blame for the financial crisis?

- **Investors for panicking and paralyzing banks**
- **Alan Greenspan for inflating the housing bubble**
- **Ben Bernanke for bursting the housing bubble**
- **Paulson, Geithner, Bernanke, etc. for bailing out all those banks**
- **Paulson, Geithner, Bernanke, etc. for <u>not</u> bailing out that one bank**
- **Congress for not passing TARP**
- **Congress for passing TARP**

- **And most importantly…**

But really, who's to blame for the financial crisis?

- …the Human Condition.
- Humans will always strive to improve their status, and will always take risks to do it.
- That will never change, and no amount of regulation can't stop the need to take risks.
- So this is <u>not</u> the last financial crisis you will ever see.

(Sorry).

A final word on inflation

We've seen pressures on consumer, interest rate, and commodity inflation, but…

…other countries are already feeling it, preparing for it:

• Canada, Australia, Malaysia, Norway and India have already started tightening

• China – put restrictions on lending to prevent bubble

Recap

- 4 Forces
- Recovery
- Inflation
- Debt, deficits
- Risks
- Conclusions

Risks

- Housing market collapses / foreclosures
- Monetary policy becomes ineffective
- New taxes and regulations
- Austerity
- Endless “Stimulus” packages
- Oil prices spike
- Protectionism
- PIIGS damage the euro-zone and us
- Global growth stagnates
- Double dip

Conclusions

EULER HERMES
Business insured. Success ensured.

- Recession over thanks to oil, interest rates, and lack of fear. Expect GDP growth of around 2% over next few years

- Recent weakness suggests recovery slowing but not stopped. Very easy to lose big picture.

- Monetary policy is aggressive, but risks inflation long term.

- Fiscal policy of huge deficits is disastrous, will cause inflation in consumption, money, and bubbles, while tax increases will surely damage growth.

- Bubbles are caused by "easy money" which will come around again some day as the credit cycle eases…

Conclusions
Arguments for double-dip / deflation or continued slow growth / inflation

Double dip / deflation
- Monetary policy ineffective
- Fiscal policy damaging
- Shaky housing market
- High unemployment
- Taxes and regulation
- Weak consumer

Slow growth / inflation
- Monetary policy set to “nuclear”
- Banks wanting to lend
- Low inflation, interest rates, labor rates (now)
- High corporate profits
- Big increase in M&A
- Rest of the world growing
- Change in WDC, fiscal policy coming
- Yield Curve very positive (leads 3-5 quarters)

Thank you
for your attention.

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